No. 92-937

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1992

RHINE REINSURANCE CO., LTD.; AMERICAN INTERNATIONAL GROUP, INC.; THE HOME INSURANCE COMPANY; NATIONWIDE MUTUAL INSURANCE COMPANY; RESOLUTE REINSURANCE COMPANY AND ARKWRIGHT MUTUAL INSURANCE COMPANY (AS SUCCESSOR IN INTEREST TO PHILADELPHIA MANUFACTURERS MUTUAL INSURANCE COMPANY),

Petitioners,

vs.

THE MUTUAL FIRE, MARINE & INLAND INSURANCE COMPANY, *et al.*,

Respondents.

Petition for a Writ of Certiorari to the Supreme Court of Pennsylvania

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Do provisions of an insurer's plan of rehabilitation that substantially limit its reinsurers' rights, as set forth in their contracts with the insurer, to setoff their obligations to the insurer against its obligations to them, thereby depriving the r einsurers of the benefit of their bargain and causing them substantial economic harm, impair and abrogate the reinsurers' contractual rights in violation of the Contract Clause of the United States Constitution?

LIST OF PARTIES

The Petitioners include Rhine Reinsurance Co., Ltd., American International Group, Inc., The Home Insurance Company, Nationwide Mutual Insurance Company, and Resolute Reinsurance Company, and Arkwright Mutual Insurance Company (as successors in interest to Philadelphia Manufacturers Mutual Insurance Company).[1] Other parties to the case include: American Centennial Insurance Co., American Financial Corp., Atlantic Mutual Fire Insurance Co., Crum and Forster, European General Reinsurance Company of Zurich, Excess and Casualty Reinsurance Association, Gerling Global Insurance Corp., The Hartford Insurance Group, Heddington Insurance, Highlands Insurance Co., Imperial Casualty and Indemnity Co., Lincoln Insurance Co., Maiden Lane Insurance Co., Michigan Mutual Insurance Co., Mid-Continent Casualty Co., Monroe Guarantee Insurance Co.,Mutual

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1. The parent companies of Rhine Reinsurance Co. Ltd. include the Baloise Insurance Co. Ltd., Berner Allgemeine Holdinggesellschaft, Patria Life Insurance Co., and Limmat Insurance Co. Ltd.

Starr International Co., Inc., The Starr Foundation, and C. V. Starr & Co. have an ownership interest in The American International Group, Inc. Its non-wholly owned subsidiaries include INTASCO Holdings Ltd., China America Insurance Co. Ltd., China America International Insurance Co. Ltd., General Environmental Management Co., Venture Enterprises Ltd., Specialty Enterprises Ltd., American International Company Ltd., AIG Financial Products Corp., Tincino Societa d'Assicurazioni Sulla Vita, Expert Network Inc., The Phillipine American Life Insurance Co., AIG Life Insurance Co., and Trace Network International Ltd.

Home Holdings, Inc. is the parent company of The Home Insurance Company.

Nationwide Cash Management is a non-wholly owned subsidiary of Nationwide Mutual Insurance Company.

Resolute Group, Inc. is the parent company of Resolute Reinsurance Company. GEICO Corporation is the parent of Resolute Group, Inc.

F.M. Insurance Company Ltd. and Factory Mutual Engineering Corporationare non-wholly owned subsidiaries of Arkwright Mutual Insurance Company.

Marine Offices, Inc., North Star Mutual Insurance Co., Northwestern National Casualty Co., Norwich Union Fire Insurance Society, Ltd., Old Republic, Pennsylvania National Insurance Companies, Royal Insurance Companies, Royal Insurance (UK), Ltd., Safety Mutual Casualty Corp., Saskatchewan Government Insurance, Scottish & York International Insurance Group, South Central Insurance Co., Sphere Drake Underwriting Management, Ltd., Utica Mutual Insurance Co., H. S. Weavers Agencies, Ltd., Willis Faber (Underwriting Management), Ltd., Wausau Insurance Companies, The Republic Insurance Group, NAIC Reinsurance Corporation, Winterthur Reinsurance Corp. of America f/k/a in the U.S. as Winterthur Swiss Insurance Co., U.S. Branch, GTE Reinsurance Co., Ltd., Christiania General Insurance Corp. of New York, Reinsurance Corp. of New York, Evanston Insurance Company, RLI Insurance Company, Pepsi-Cola Bottling Co. of Charlotte, Inc., Pennsylvania Insurance Guaranty Association, Allstate Insurance Co., Fireman's Fund Insurance Co., Interstate Fire & Casualty Co., and Committee of Policyholders.

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OPINIONS BELOW

The Opinion of the Pennsylvania Supreme Court is not officially or unofficially reported, and is set forth in Appendix "A". The Opinion of the Commonwealth Court is reported at 132 Pa. Commw. 196, 572 A.2d 798 (1990), and is set forth in Appendix "B".

STATEMENT OF DATE OF ENTRY OF JUDGMENT AND STATUTORY PROVISION CONFERRING JURISDICTION

The judgment of the Pennsylvania Supreme Court was entered on August 21, 1992. Jurisdiction of this Court is conferred by 28 U.S.C. § 1257.

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

Article I, § 10 — Contract Clause

> No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

40 P.S. § 221.15 — Rehabilitation Orders

> (a) The commissioner may apply by petition to the Commonwealth Court, for an order authorizing him to rehabilitate a domestic insurer or an alien insurer domiciled in this

Commonwealth, alleging that the insurer has committed one or more acts which may constitute grounds for rehabilitation as set forth in section 514 of this article.

(b) An order of the Commonwealth Court to rehabilitate the business of an insurer shall be issued only after a hearing before the court or pursuant to a written consent of the insurer.

(c) An order to rehabilitate the business of a domestic insurer, or an alien insurer domiciled in this Commonwealth, shall appoint the commissioner and his successors in office the rehabilitator, and shall direct the rehabilitator forthwith to take possession of the assets of the insurer including any deposits held by the commissioner, and to administer them under the orders of the court. The filing or recording of the order with the clerk of the Commonwealth Court or recorder of deeds of the county in which the principal business of the company is conducted, or the county in which its principal office or place of business is located, shall impart the same notice as a deed, bill of sale or other evidence of title duly filed or recorded with that recorder of deeds would have imparted.

(d) Entry of an order of rehabilitation shall not constitute an anticipatory breach of any contract of the insurer.

40 P.S. § 221.16 — Powers and Duties of the Rehabilitator

* * * *

(d) The rehabilitator may prepare a plan for the reorganization, consolidation, conversion, reinsurance, merger or other transformation of the insurer. Upon application of the rehabilitator for approval of the plan, and after such notice and hearing as the court may prescribe, the court may either approve or disapprove the plan proposed, or may modify it and approve it as modified. If it is approved, the rehabilitator shall carry out the plan....

40 P.S. § 221.32 —Setoffs and Counterclaims

(a) Mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article shall be setoff and the balance only shall be allowed or paid, except as provided in subsection (b).

(b) No setoff or counterclaim shall be allowed in favor of any person where:

(1) the obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer;

(2) the obligation of the insurer to the person was purchased by or transferred

to the person with a view to its being used as a setoff;

(3) the obligation of the person is to pay an assessment levied against the members or subscribers of the insurer, or is to pay a balance upon a subscription to the capital stock of the insurer, or is in any other way in the nature of a capital contribution; or

(4) the obligation of the person is to pay premiums, whether earned or unearned, to the insurer.

STATEMENT OF THE CASE

This is a proceeding pursuant to 40 P.S. § 221 *et seq.* for rehabilitation of a domestic insurer, Mutual Fire, Marine & Inland Insurance Company ("Mutual Fire"). On December 4, 1986, the Pennsylvania Insurance Department filed a petition to rehabilitate Mutual Fire in the Commonwealth Court of Pennsylvania. The Insurance Commissioner of Pennsylvania sought and was granted appointment as Rehabilitator of Mutual Fire pursuant to 40 P.S. § 221.15(a). At that time, the Commissioner submitted a plan of rehabilitation pursuant to 40 P.S. § 221.16(d).

On January 31, 1989, the Rehabilitator submitted a modified Plan of Rehabilitation (the "Plan") and requested Commonwealth Court approval. On or about April 7, 1989, Petitioners, creditors of Mutual Fire pursuant to various contracts of reinsurance known as "treaties" (the "Treaties"), filed objections to the Plan. Among the objections were that the Plan's definition of the obligations running from Petitioners to Mutual Fire that could be setoff against those from Mutual Fire to Petitioners was more limited than that

specified in the Treaties, and that the Plan thereby impaired and abrogated Petitioners' contractual rights in violation of Article I, § 10 of the Constitution. On July 25, 26, 28 and August 1, 1989, a hearing was held before the Commonwealth Court on the Rehabilitator's request to confirm the Plan. At that hearing, Petitioners introduced expert testimony on the adverse effect the difference between the Plan's definition of setoff and what the Treaties provide would have on Petitioners' settlement of outstanding balances with Mutual Fire.

On January 23, 1990, The Commonwealth Court (Crumlish, Jr., J.) entered an opinion and order modifying and approving the Plan, which it amended on February 26 and April 18, 1990. The Plan, as ultimately approved by the Commonwealth Court, contained the restrictive setoff definition objected to by Petitioners. The Commonwealth Court rejected Petitioners' Contract Clause arguments, finding the "alleged impairments are, for the most part, insubstantial and do not warrant modification of the Plan except as hereinafter provided." 54a.

Petitioners filed a timely appeal of the Commonwealth Court's decision with the Pennsylvania Supreme Court. Among the questions they raised for review was whether the Plan impaired and abrogated their contractual rights in violation of the Contract Clause. The Pennsylvania Supreme Court considered and rejected this argument, ruling in an opinion by Nix, J., dated August 21, 1992, that the "Commonwealth Court properly upheld this portion of the Plan and concluded that in order to achieve the desired consequence of satisfying all claims in an equitable and orderly manner, the resulting alleged contract impairments were insubstantial." 16a, n. 4. The Pennsylvania Supreme Court also entered its judgment on August 21, 1992.

REASONS FOR GRANTING THE WRIT

The Pennsylvania Supreme Court opinion of which review is sought represents the first decision by the highest court of a state that an insurance company in rehabilitation is not bound by its contractual obligations to other insurance companies, including Petitioners, with which it agreed to share certain risks. The Pennsylvania Supreme Court's decision will provide authority that will be used by rehabilitators of financially-impaired insurance companies throughout the country, and the courts supervising them, to retroactively reorder the companies' financial arrangements with Petitioners and other reinsurers. The consequences to Petitioners' financial security and revenues will be profoundly adverse.[2]

A writ of certiorari should be issued because the substantial impairments of Petitioners' contractual rights effected by the Pennsylvania Supreme Court resulted from its misapplication of, or utter failure to consider, certain criteria this Court has established for analyzing state actions that may violate Article I, § 10 of the Constitution. Alternatively, this Court should summarily reverse the Pennsylvania Supreme Court's decision, and remand the matter for further consideration in light of the settled authority of this Court. This Court has clearly and consistently held that a state may not substantially impair a private contractual agreement unless it can demonstrate an important public purpose for doing so. *Energy Reserves Group Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411-12 (1983). The Rehabilitator could not meet this test in the present case. She was not required by the Pennsylvania

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2. One industry industry expert, testifying at the hearing on confirmation of the Plan before the Commonwealth Court, stated that the Plan's "circumscription" of the Petitioners' offset obligations will "create havoc" in the reinsurance industry. Transcript of Hearing on Confirmation of Plan, Volume III, at 491 (July 28, 1989).

Supreme Court to do so, however, as the Court accepted without question her decisions concerning the modification of Mutual Fire's contractual obligations. *Energy Reserves* does not permit such deference to the Rehabilitator, and requires the relief sought by the Petitioners.

I.

FACTUAL BACKGROUND

Under the Treaties, each Petitioner agreed to transfer, or "cede," to Mutual Fire a portion of the risks it had agreed to accept from other insurance companies. Petitioners paid premiums to Mutual Fire for these ceded risks, and in return, Mutual Fire contracted with Petitioners to "assume" the risks, and thereby to pay a share of any losses incurred by the Petitioners as a result of the risks.[3] Mutual Fire and Petitioners entered into other Treaties in which their positions were reversed; Petitioners agreed to assume a portion of the losses incurred by Mutual Fire for certain risks, and in return were paid premiums.

Under the Treaties, loss payments owed by the assuming party to the ceding party were divided into categories. They included reimbursement of actual losses incurred by the ceding party, and reimbursement of the ceding party's expenses in adjusting the losses it incurred (known as "loss adjustment expenses" or "LAE"). Combined, these two types of payments are known as

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3. The record below includes a treaty (the "AIG Treaty") between Mutual Fire and Petitioner American International Group ("AIG"), which was introduced and accepted as representative of the Treaties. Article IX provides that Mutual Fire "shall pay a pro rata share of all expenses incurred by" AIG "in the investigation, adjustment and litigation of all claims. . ." Cedent's Exhibit 1 to Hearing on Confirmation of Plan.

"due and owing", and were so characterized in the record below.[4] They also included reimbursement of estimated amounts to be incurred by the ceding party for losses associated with claims reported but not yet paid (known as "case reserves"),[5] and reimbursement for losses associated with events insured against that have occurred but for which no claim has been reported (known as "incurred but not reported losses" or "IBNR").[6]

The Treaties provided a mechanism under which each party had the right to deduct sums owed to it by the other party from sums it owed to that party. This produced a smaller net balance between the parties that greatly simplified the accounting arrangements between them, represented a form of security because it reduced the amount of credit being held by one party against the other, and reflected long-established principles governing mutual debts.[7]

---

4. The term "due and owing" is defined in the Plan, for example, as "[r]einsurance recoverable on paid losses, paid Loss Adjustment Expenses, claim settlements and reimbursement agreements." Plan at 2.

5. The term "case reserves" is defined in the Plan as "[t]he aggregate estimated amounts of Claims reported but not adjusted...." Plan at 1.

6. "IBNR" losses are defined in the Plan as "[l]osses that have occurred but have not been reported, and development of reported Claims, the estimated amounts of which has been statistically determined by independent actuaries based on data regarding the history of Mutual Fire's losses and insurance industry data." Plan at 2.

7. In Pennsylvania, setoff

> has been a guiding principle in the business life of our people for more than two centuries and is founded on the natural justice and equity that in all cases of mutual credit only the balance should be paid."

(Cont'd)

Article XVII of the AIG Treaty, for example, titled "Offset Clause," provided that

> 1. Each party hereto shall have, and may exercise at any time and from time to time, the right to offset any balance or balances, whether on account of premiums or on account of losses or otherwise, due from such party to the other (or, if more than one, any other) party hereto under this Agreement or under any other reinsurance agreement heretofore or hereafter entered into by and between them, and may offset the same against any balance or balances due or to become due to the former from the latter under the same or any other reinsurance agreement between them; and the party asserting the right of offset shall have and may exercise such right whether the balance or balances due or to become due to such party from the other are on account of premiums or on account of losses or otherwise and regardless of the capacity, whether as assuming insurer or as ceding insurer, in which each party acted under the Agreement or, if more than one, the different agreements involved, provided, however, that in the event of the insolvency of a party hereto, offsets shall be allowed in accordance with the provisions of Section 533 of the Insurance Law of the State of New York.

(Cont'd)

Fisher v. Davis, 278 Pa. 129, 122 A. 224, 225 (1923). The Ninth Circuit has held that offsetting of debts by a reinsurance pool is favored, as it "not only spreads risk but also acts as mutual security for performance." *Stamp v. Insurance Company of North America*, 908 F.2d 1375, 1380 (7th Cir. 1990).

This type of offset clause, typical of those found in the Treaties, allowed the Petitioners to setoff the following as a matter of right:

1) premiums they owed Mutual Fire as ceding reinsurers under a particular treaty against due and owing, case reserves and IBNR owed to them by Mutual Fire under that treaty;

2) due and owing, case reserves and IBNR they owed Mutual Fire as assuming reinsurers under a particular Treaty against premiums owed them by Mutual Fire under that treaty;

3) premiums as well as due and owing, case reserves and IBNR they owed under a particular treaty against sums owed them by Mutual Fire under *another* treaty.

The Treaties contained no provision affecting either party's offset right in the event of Respondent's rehabilitation.[8] To the

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8. Article XVII of the AIG Treaty provides that in the event of a party's insolvency, offset will be allowed as permitted by New York State statute. The statute, Section 535 of the New York State insurance law, N.Y. Law § 7427, generally permits setoff except in limited circumstances, not applicable to the present case, where:

> (1) the obligation of the insurer to such person would not at the date of the entry of any liquidation order or otherwise, as provided in 7405 of this Article, entitle him to share as a claimant in the assets of such insurer, or
>
> (2) the obligation of the insured to such person was purchased by or transferred to such person with the view of it being used as an offset, or
>
> (3) the obligation of such person is to pay an assessment levied against the members of a mutual insurer or to pay a balance upon a subscription to the shares of a stock insurance corporation.

contrary, a provision of the Pennsylvania insurance law, 40 P.S. § 221.32 (a), *requires* the setoff of mutual debts and mutual credits involving an insurance company in rehabilitation. The Plan drafted by the Rehabilitator and approved by the Pennsylvania Supreme Court, however, substantially impairs the setoff rights awarded Petitioners by the Treaties, by:

1) limiting the mutual debts and credits that may be setoff against one another to those "due and owing" between the parties, thereby precluding setoff of case reserves and IBNR (Plan at 14);[9]

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9. The Plan, as modified, contains an "optional setoff definition" made available only to reinsurers that, unlike Petitioners, settled their balances with Respondent within 90 days of the Order confirming the Plan:

> "Any Reinsurer of Mutual Fire who is also a Cedent to Mutual Fire will be permitted to setoff the lesser of Mutual Fire's obligations to the Cedent against the Reinsurer's obligations to Mutual Fire according to Mutual Fire's books pursuant to the following calculation:
>
> Option Setoff Calculation - The lesser of:
>
> a. Mutual Fire's obligation to the Cedent for:
>
> balances Due and Owing, plus reported Case Reserves, plus reported IBNR
>
> All as computed as of December 4, 1986; or
>
> b. The Cedent's obligation to Mutual Fire for:
>
> balances Due and Owing, plus Case Reserves.
>
> All as computed as of December 4, 1986.

2) limiting the date on which setoff may take place to December 4, 1986, thereby precluding setoff of items that arose thereafter (Plan at 14); and

3) prohibiting the setoff of "obligations to pay premiums to Mutual Fire" (Plan at 13).[10] The Plan contains no reciprocal prohibition against the setoff of premiums owed by Mutual Fire.

The adverse implications to Petitioners of this unilateral modification of their contractual rights are severe. Because of the December 30, 1986 cutoff date and the restrictions on categories of debts that may be considered, offset is no longer available to the Petitioners as a method for reducing the costs of monitoring and reconciling balances between them and Mutual Fire. Equally importantly, the Petitioners are deprived of the security that the balances they owe Mutual Fire provide against sums they are owed, a matter of particular concern given Mutual Fire's financial condition.

The Treaties were entered into by insurance companies experienced in matters of reinsurance. Each recognized the possibility that the other party might experience financial difficulties while the Treaties were in force. The Treaty provisions

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(Cont'd)

Mutual Fire's IBNR is specifically excluded from Section (b) of this calculation."

Thus, even the "optional" definition does not permit the setoff of Petitioners' IBNR.

10. This provision of the Plan reflects Pennsylvania state law forbidding the setoff of obligations to pay premiums to an insurer in rehabilitation. 40 P.S. 221.32(a)(4). Petitioners contend that this provision of the state statute, like the Plan, violates the Contract Clause of the Constitution.

reflect the manner in which they agreed to deal with this possibility. The Plan, as confirmed by the Pennsylvania Supreme Court, destroys the contractual balance struck by the parties, fundamentally reorders their bargaining relationship, and creates authority under which similar contracts with other insurers now or to become insolvent to which Petitioners are a party may be impaired by insurance rehabilitators across the country. As the Pennsylvania Supreme Court confirmed the Plan without properly evaluating Petitioners' Contract Clause claims, a writ of certiorari should be granted to review its decision, or in the alternative its decision should be summarily reversed.

II.

THE CONTRACT CLAUSE PROHIBITS THE ABROGATION OF PETITIONERS' SETOFF RIGHTS IN THE MANNER REQUIRED BY THE PLAN.

The Plan's impairments of Petitioners' contractual rights of setoff contravene Article I, 10 of the United States Constitution (the "Contract Clause"), which provides that "no state shall . . . pass any law impairing the obligation of contract." The Plan, developed by the Commonwealth's Insurance Commissioner as required by statute, 40 P.S. § 221.14 *et seq.*, and modified and approved by the courts of Pennsylvania pursuant to the same statute, is a state "law." *Atlantic Coast Line Railroad Company v. City of Goldsboro,* 232 U.S. 548 (1914); *Grand Trunk Western Railway Company v. Railroad Commission*, 221 U.S. 400, 403 (1911) (order of state railroad commission is a "legislative act by an instrumentality of the state exercising delegated authority...and so is a law of the state within the meaning of the Contract Clause of the Constitution"). In approving the Plan, the Pennsylvania Supreme Court improperly applied the standard established by this Court for review of a Contract Clause claim. As a result, its decision conflicts with the settled law of this Court.

A. The Pennsylvania Supreme Court Failed to Consider or Determine That the Plan Substantially Impairs Petitioners' Contractual Obligations.

In *Energy Reserves,* this Court established a three-part test under which Contract Clause claims are to be evaluated. 459 U.S. at 411. Citing *Allied Structural Steel Co. v. Spannaus,* 438 U.S. 234 (1978), and *United States Trust Co. v. New Jersey,* 431 U.S. 1 (1977), this Court held "the threshold inquiry is whether the state law has, in fact, operated as a substantial impairment of a contractual relationship." In *United States Trust Co.,* this Court ruled that a state could not retroactively alter a statutory bond covenant relied upon by bond purchasers. In *Spannaus,* this Court struck down a state law requiring an employer terminating its pension plan to provide certain substitutes, on the ground that the law "substantially altered" the employers' contractual relationships with its employees "conspicuously beyond those that it had voluntarily agreed to undertake." 438 U.S. at 240.

In *Spannaus,* this Court found, after reviewing its prior Contract Clause decisions, that "it must be understood to impose *some* limits upon the power of a State to abridge existing contractual relationships, even in the exercise of its otherwise legitimate police power." 438 U.S. at 241 (emphasis in original). It held that

> The severity of an impairment of contractual obligations can be measured by the factors that reflect the high value the Framers place on the protection of private contracts. Contracts enable individuals to order their personal and business affairs according to their particular needs and interests. Once arranged, these rights and obligations are binding under the

> law, and the parties are entitled to rely on them.[11]

438 U.S. at 245. It confirmed that "[t]otal destruction of contractual expectations is not necessary for a finding of substantial impairment." *Energy Reserves*, 459 U.S. at 411.

Under this standard, there is no question that the Plan's limitations on setoff represent a severe impairment of Petitioners' contractual rights. The increased accounting costs, the loss of security, and the elimination of Petitioners' bargained-for contingency against financial reverses on the part of Mutual Fire, combined with the prospect that Petitioners' contractual rights with other insolvent insurers will be abrogated under the authority of the present decision have fundamentally altered the agreement Petitioners bargained for. The treaties specified the financial arrangements between Petitioners and Respondent precisely in order that Petitioners might, in the words of this Court in *Spannaus*, "order their . . . business affairs" accordingly. The Plan, just like the law at issue in *Spannaus* before it was overturned by this Court, "nullifies express terms of the [Petitioners'] contractual obligations and imposes a completely unexpected liability in potentially disabling amounts. There is not even any provision for gradual applicability or grace periods." 438 U.S. at 247.

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11. As this Court noted in *Home Building & Loan Association v. Blaisdell*, 290 U.S. 398, 428 (1934), Chief Justice Marshall summarized the "Framers" concern in his observation that, at the time the Constitution was drafted, "[t]he power of changing the relative situation of debtor and creditor, of interfering with contracts, a power which comes home to every man, touches the interest of all, and controls the conduct of every individual in those things which he supposes to be proper for his own exclusive management, had been used to such an excess by the state legislatures, as to break in upon the ordinary intercourse of policy, and destroy all confidence between man and man." *Citing Ogden v. Saunders*, 12 Wheat. 213, 354-55 (1827).

The Pennsylvania Supreme Court completely misapplied this aspect of the *Energy Reserves* test. It concluded that the Commonwealth Court had properly determined that "the resulting alleged contract impairments were insubstantial" given the Plan's design "to achieve the desired consequence of satisfying all claims in an equitable and orderly manner." This Court has made clear that the significance of the impairment of party's contractual right is to be determined *not* in relation to any purpose for the impairment, but rather in light of "the factors that reflect the high value the Framers placed on the protection of private contracts." *Spannaus*, 438 U.S. at 245. Moreover, the fact that legislation has some worthwhile purpose is not sufficient, by itself, to protect it from a Contract Clause challenge. *Spannaus*, 438 U.S. at 250 ("[i]t is not necessary to hold that the Minnesota law impaired the obligation of the company's employment contracts 'without moderation or reason or in a spirit of oppression.' " *Citing W. B. Worthen Co. v. Kavanaugh*, 295 U.S. 56, 60 (1935)). The Pennsylvania Supreme Court gave no consideration to such factors. Instead, it did precisely the opposite by completely deferring to the "determinations of fact and public policy made by the Rehabilitator." (9a). The Pennsylvania Supreme Court's failure to even consider the impairments suffered by Petitioners, which are patently substantial in their fiscal magnitude, their suddenness, and their irrevocability, warrants review of its decision, if not summary reversal.

B. The Pennsylvania Supreme Court Failed to Consider or Determine Whether The Plan Furthers a "Significant and Legitimate Public Purpose" or "Imposes Reasonable Conditions of a Character Appropriate to" that Purpose.

The *Energy Reserves* decision further established that "if the state regulation constitutes a substantial impairment, the State, in justification, must have a significant and legitimate public purpose behind the regulation . . . such as the remedying of a broad and general social or economic program." 459 U.S. at 411-12.

Moreover, the "[l]egislation adjusting the rights and responsibilities of contracting parties must be upon reasonable conditions and of a character appropriate to the public purpose justifying its adoption." *United States Trust Co.*, 431 U.S. at 21; *Energy Reserves*, 459 U.S. at 412.

The Pennsylvania Supreme Court failed to even consider these standards in erroneously concluding that the Plan did not violate the Contract Clause. Rather, the Court deemed it sufficient to find that the Plan furthered the State's "significant interest" in regulating "the fiscal affairs of its insurers for the welfare of the public." (54a). The effect of the Plan's abrogation of setoff rights held by Petitioners, however, is solely to advantage another class of Mutual Fire's creditors — the policyholders — who will share in a greater proportion of Respondent's assets than if the assets were distributed to Petitioners. This Court has consistently found that states must act, to survive a Contract Clause challenge, "for the protection of a basic interest of society," and "not for the mere advantage of particular individuals." 290 U.S. at 445. The Plan provisions at issue provide "a benefit to special interests," which is precisely what this Court has held a legislature may *not* do under the Contract Clause. *Energy Reserves*, 459 U.S. at 412; *See Spannaus*, 438 U.S. at 248-49 (a statute "aimed largely at a single employer or, at the most, a small group of employers, can hardly be characterized . . . as one enacted to protect a broad societal interest rather than a narrow class," and cannot be upheld).

The Pennsylvania Supreme Court's reference to the public welfare is, therefore, sheer nonsense, for the interests of the population at large are unaffected by the Plan provisions at issue. The present case may readily be contrasted with *Energy Reserves*, in which a state statute regulating the price of natural gas was found to protect all "consumers from escalation of natural gas prices caused by deregulation," and in particular those who "use gas heat but must exist on limited fixed incomes." 459 U.S. at

413.[12] The reordering of assets created by the Plan provisions do not constitute the "broad and general social or economic program" required by *Energy Reserves* to justify the resulting impairment of Petitioners' contractual rights.

Furthermore, in *Spannaus*, this Court held that the statute at issue must be "*necessary* to meet an general social problem." 438 U.S. at 247. More than just a general concern for the public welfare must be at issue. This Court, in *Spannaus*, noted earlier decisions that had struck down state laws as impairing contractual obligations in spite of the argument that the statutes were necessitated by "the public welfare," *Ibid.* This Court took particular note of its decision in *Treigle v. Acme Homestead Association*, 297 U.S. 189 (1936), in which it ruled unconstitutional a state law permitting the "abrogation of contracts between" members of a building and loan association and the association that were "lawful when made," finding that

> Such an interference with the right of contract cannot be justified by saying that in the public interest the operations of building associations may be controlled and regulated, or that in the same interest their charters may be amended.

297 U.S. at 196. The Pennsylvania Supreme Court opinion makes no reference to a "social problem" being addressed by the Plan's provisions; to the contrary, the Opinion makes clear that the Court did not believe it needed to ever consider this question. Accordingly, it certainly made no finding that the setoff provisions were "necessary" to meet such a problem.

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12. By contrast, the argument that a rehabilitator must refuse to apply rules of setoff in order to protect the losses of primary policyholders was rejected by the California Court of Appeals in *Prudential Reinsurance Co. v. Superior Court*, 256 Cal. Rptr. 386, 399 (1990).

Moreover, even if the Plan did address an important social problem, it does not impose "reasonable conditions" with respect to, nor is it "of a character appropriate to" that purpose. *United States Trust Co.*, 431 U.S. at 21. Interest in "regulating the fiscal affairs of its insurers" does not entitle the state to arbitrarily decide what sums may or may not be paid to and from such insurers in spite of their contractual agreements. This Court has never allowed the state unfettered discretion to completely rewrite private agreements, even for the sake of important public interest. Rather, in *Spannaus*, it held that the "presumption favoring 'legislative judgment as to the necessity and reasonableness of a particular measure'. . . simply cannot stand" in the face of a severe "disruption of contractual expectations." 438 U.S. 247, *citing United States Trust Co.*, 431 U.S. at 23. Thus, the Pennsylvania Supreme Court was required to critically examine the Plan provisions and determine independently whether they were reasonably related to their asserted purpose. It failed to do so, and thus failed to consider that whatever goals the Rehabilitator sought to have achieved might be accomplished equally well, or better, by actions less financially detrimental to Petitioners or disruptive of their business arrangements. This failure warrants review, if not summary reversal, by this Court.

CONCLUSION

The Supreme Court of Pennsylvania is the first state supreme court to declare that one insurer's contractual agreements with another are meaningless when it enters rehabilitation. It has provided a basis for one or more of the many courts administering similar insurance rehabilitations across the country to reach the same conclusion. The Supreme Court reached its decision without acknowledging that, in order to comply with this Court's directions, it was required to independently examine the Plan provisions at issue and determine whether a substantial impairment of Petitioners' contractual rights had occurred, a significant public purpose was served thereby, and the provisions were reasonably drafted to effectuate that purpose. Its decision, therefore, was improperly reached and should not be permitted to stand as authority for the radical restructuring of Petitioners' contractual rights, either in Pennsylvania or nationwide. This Court should grant the Petitioners' Petition in order to correct the Pennsylvania Supreme Court's failure to act consistently with the Court's directives in evaluating claims under the Contract Clause.

Respectfully submitted,

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Attorneys for Petitioners

APPENDIX A — OPINION OF THE SUPREME COURT OF PENNSYLVANIA DATED AUGUST 21, 1992

[J-108-1990]

IN THE SUPREME COURT OF PENNSYLVANIA

MIDDLE DISTRICT

Nos. 28 and 71 M.D. Appeal
Dockets 1989 and
Nos. 15 thru 24 M.D. Appeal
Dockets 1990

Appeal from the Orders of the Commonwealth Court dated March 17, 1989, November 22, 1989, AND JANUARY 23, 1990 23, 1990, AT NO. 3483 CD 1986

132 Pa. Commw. 196
572 A.2d 798 (1990)

ARGUED: May 8, 1990

CONSTANCE B. FOSTER Insurance Commissioner of the Commonwealth of Pennsylvania

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY

Appendix A

APPEAL OF: Committee of Policyholders at Nos. 28/71 1989

APPEAL OF: Colonial Penn Group, Inc. at No. 15/90

APPEAL OF: Allstate Insurance Company at No. 16/90

APPEAL OF: AIG Risk Management, et al. at No. 17/90

APPEAL OF : Pepsi-Cola Bottling Co. of Charlotte, Inc., et al. at No. 18/90

APPEAL OF: Fireman's Fund Insurance Co. and Interstate Fire and Casualty Co. at No. 19/90

APPEAL OF: Committee of Policyholders at No. 20/90

APPEAL OF: Evanston Insurance Co. at No. 21/90

APPEAL OF: RLI Insurance Co. at No. 22/90

APPEAL OF: PA. Insurance Guaranty Assn. (PIGA) at No. 23/90

APPEAL OF: The Member Companies of The Republic Insurance Group, et al. at No. 24/90

OPINION

NIX, C.J. DECIDED: AUGUST 21, 1992

This is an appeal from the Order of the Commonwealth Court modifying, and then approving, a Rehabilitation Plan ("Plan") for Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire"), submitted by Appellee, Constance Foster, Insurance

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Commissioner of the Commonwealth of Pennsylvania ("Commissioner or Rehabilitator"), pursuant to Section 515(a) of Article 5 of the Act of May 17, 1921, P.L. 789, *as amended*, by the Act of December 14, 1977, P.L. 280, 40 P.S. § 221.15 (known as the Insurance Department Act of 1921). While numerous Appellants challenge the Plan on multiple and varying grounds, the threshold issue to be resolved is whether the Plan as submitted legally represents a legitimate plan of Rehabilitation or whether the Plan, in reality, is a *de facto* liquidation plan, filed by the Rehabilitator lacking any rehabilitative purpose, thus constituting an abuse of her discretion. Should this Court find that the proposed Plan represents a liquidation instead, the numerous appeals herein, which challenge specific provisions of the Plan of rehabilitation, would be rendered moot.

FACTS

The facts, as presented in the opinion of the Commonwealth Court, have been adopted and incorporated for our purposes herein.

In December 1986, George F. Grode, then Commonwealth Insurance Commissioner, sought, with the consent of Mutual Fire's officers and directors, appointment as Rehabilitator of Mutual Fire, Section 515(a) of the Act, 40 P.S. § 221.15(a), and submitted a rehabilitation plan. Prior to this petition, Commissioner Grode had placed Mutual Fire under his supervision. Section 510(d) of the Act, 40 P.S. §221.10(d). At the time the petition was filed, Mutual Fire reported assets of $99.4 million and total liabilities of $260.1 million, with a negative policyholders' surplus of nearly $161 million.

When it became apparent to the Commonwealth Court that adequate notice had not been given to policyholders and other

creditors on whom the original plan would have a direct and substantial impact, hearing on the Plan's approval was continued generally. At the same time, the Court directed the Insurance Department to prepare a notice of hearing to be sent to all known policyholders and ceditors indicating the procedure for obtaining the plan and raising objections prior to a Court hearing on its approval. Thereafter, many objections were made. These objections were drawn from individual policyholders, claimants against policyholders, reinsurers doing business with Mutual Fire, creditors and agents of Mutual Fire.

In early 1987, upon application of several policyholders, also objectors to the plan, the Commonwealth Court formed a Committee of Policyholders (Policyholders Committee), whose purpose was to "consult with the statutory rehabilitator on the administration of this matter and advise those represented as to the proposed plan." The Commonwealth Court formed the Policyholders Committee with the express intent of assuring that policyholders *first and foremost* suffered the least amount of harm resulting from the unfortunate series of events culminating in this insurance company's reorganization effort.

The Rehabilitator, now Commissioner Foster, thereafter filed her responses to the objections to the proposed rehabilitation plan. The Policyholders Committee and Numerous other parties strenuously objected to this proposed plan on the grounds, *inter alia,* that the Rehabilitator had released no financial information or documentation to substantiate the projections of 100% payment to policyholders contained therein. Hence, the court ordered the Rehabilitator to allow the Policyholders Committee and all interested persons access to Mutual Fire's books and records. A hearing date was then set for June 3, 1987.

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At that hearing, various stipulations by and among the objecting parties (including the Policyholders Committee) were entered. The proposed plan was approved, subject to those stipulations, which altered it materially but in a manner not pertinent to this discussion.

Several months later, the Rehabilitator, pursuant to the court's Order approving the proposed plan, filed a report on the progress of the rehabilitation for the period from December 8, 1986 (the date on which the statutory Rehabilitator was appointed) to October 26, 1987. At the same time, the Rehabilitator sought additional time to evaluate the feasibility of its implementation. The court granted the Rehabilitator's request for additional time and directed her to submit to the court a schedule of tasks to be performed in order to complete the evaluation. Among these tasks were the engagement of litigation counsel to investigate possible causes of action by the Rehabilitator on behalf of Mutual Fire, Section 516(c) of the Act, 40 P.S. § 221.16(c); the appointment of a professional firm to perform actuarial analyses of Mutual Fire's loss reserves; and the engagement of auditing and claims settlement services, Section 516(b) of the Act, 40 P.S. § 221.16(b). At that time, the Rehabilitator opposed the Policyholders Committee's motion to appoint an independent manager to oversee the rehabilitation on site.

On May 2, 1988, the Rehabilitator filed her report on the feasibility of implementing the amended plan approved June 26, 1987. After close consultation, pursuant to Section 515(c) of the Act, 40 P.S. § 221.15(c), the court and Commissioner Foster determined that any viable rehabilitation of this magnitude would necessarily demand sufficient legal, managerial, financial and technical resources. It was therefore decided that initially a deputy rehabilitator would be appointed, Section 516(a) of the Act, 40 P.S.

§ 221.16(a) , and legal counsel would be retained to investigate possible sources of recovery through litigation where litigation was deemed fruitful to collect the recoverables comprising a significant portion of this estate's assets.

On June 1, 1988, having reviewed the Rehabilitator's report on Plan implementation, which indicated the 1987 Plan was not feasible for several reasons, the court directed the Rehabilitator to submit a modified plan. The plan was to include a provision to trigger applicable state insurance guarantee funds (both in Pennsylvania and other states) and a provision for proportionate periodic payments of policyholders's claims. Additional counsel was hired to assist the Rehabilitator in formulating a modified plan.

Thereafter, the Rehabilitator applied to the Commonwealth Court for approval to suspend payment of certain loss adjustment expenses incurred under Mutual Fire's obligations to defend its insureds. The Rehabilitator also asked the court for a determination that Mutual Fire was insolvent.

The Rehabilitator submitted a new Plan of Rehabilitation on January 31, 1989. After notice was issued to policyholders and all known creditors and was published in periodicals of general and industry circulation, numerous objections were filed. The Commonwealth Court, over the course of four days, heard testimony and argument in support of and against certain provisions of the Plan. The Commonwealth Court (Crumlish, P.J.) approved the Plan with certain modifications, and the instant appeal followed.

The Appellants in this matter are several insurance companies, policyholders and other ceditors who have claims

against Mutual Fire or other financial interests in the disposition of the company's assets. Specifically, the insurance companies are engaged in reinsurance or cedent[1] relationships with Mutual Fire, and the Committee of Policyholders, which has appeals at Nos. 20, 28 and 71, represents policyholders whose outstanding claims with Mutual Fire have yet to be paid.

SCOPE OF REVIEW

The General Assembly, in recognition of the specialized complexities involved in insurance generally, and in the regulation of this industry in particular, assigned the task of overseeing the management of that industry, in this Commonwealth, to the Insurance Department, the agency having expertiese in that field. 40 P.S. § 41, *et seq.* The Insurance Commissioner, an appointed position pursuant to 40 P.S. § 42 is, therefore, afforded broad supervisory powers to regulate the insurance business in this Commonwealth, including the power to protect "the interests of insureds, creditors, and the public generally. . . ." 40 P.S. § 221.1(c). Accordingly, the delegation of such caretaking authority necessarily includes exercising a direct role in the rehabilitation of insolvent insurers. Subsection (c) of Section 515 of the Insurance Act, 40 P.S. § 221.15, authorizes the Insurance Commissioner in her capacity as Rehabilitator "to take possession of the assets of the insurer . . . and to administer them under the orders of the court."

Upon petition by the Commissioner to the Commonwealth Court for an Order authorizing him or her to rehabilitate an insurer

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1 Cedents are those companies whom Mutual Fire reinsures. Plan of Rehabilitation, Section I(4).

pursuant to 40 P.S. § 221.15(a) and once such a rehabilitation plan has been ordered, the Rehabilitator is charged to "take such action as [s]he deems necessary or expedient to correct the condition or conditions which constituted the grounds for the order of the court to rehabilitate the insurer." 40 P.S. § 221.16(b). This mandate explicitly defers all actions to the skill of the Rehabilitator and implicitly recognizes her expertise in these matters. Additionally, the Rehabilitator is granted the power to retain those persons necessary to assist in the rehabilitation process. 40 P.S. § 221.16(a) ("Powers and Duties of the Rehabilitator").

Once the Insurance Commissioner and her deputies have designed a plan of rehabilittion it must be submitted to the Commonwealth Court for approval in order that it may have efficacy. The Commonwealth Court is empowered by the General Assembly to supervise and review the activities and proposals of the Insurance Commissioner while she undertakes the rehabilitation of an insolvent insurer. 40 P.S. § 221.4(a); 42 P.S. § 761(a)(3). In overseeing the course of rehabilitation to check any abuse of discretion by the Commissioner, the Commonwealth Court is authorized to "approve or disapprove the plan [of rehabilitation] proposed, or may modify it and approve it as modified. If it is approved, the rehabilitator shall carry out the plan." 40 P.S. § 221.16(d). Therefore, in order for the Plan to warrant the Commonwealth Court's imprimatur it must be found to be free from any abuse of the Rehabilitator's discretion.

Instantly, the Rehabiltator recommended a final, amended Plan of Rehabilitation to the Commonwealth Court on January 31, 1989. The group of policyholders designated to represent many creditors of Mutual Fire were notified of the specifics of the Plan and numerous objections were filed. After hearing several days of testimony and argument the Commonwealth Court approved the

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Plan with certain modifications by Order dated January 23, 1990, and we now address those objections raised against the Plan.

As is evident from the above referenced statutory provisions, both the Insurance Commissioner and the Commonwealth Court are obligated to interact in order to supervise, implement and regulate equitably the process engaged to rehabilitate an insolvent or financially hazardous insurer. As a result of these specific assignments, it is not the function of the courts to reassess the determinations of fact and public policy made by the Rehabilitator. Rather, the involvement of the judicial process is limited to the safeguarding of the plan from any potential abuse of the Rehabilitator's discretion. In summarizing the law of this Commonwealth concerning judicial review of the determinations made by administrative agencies, we have stated:

> 'It has been established as an elementary principle of law that courts will not review the actions of governmental bodies or administrative tribunals involving acts of discretion *in the absence of bad faith, fraud, capricious action or abuse of power* . . . . That the court might have a different opinion or judgment in regard to the action of the agency is not a sufficient ground for interference; *judicial* discretion may not be sustituted for *administrative* discretion.'

Norfolk & Western Railway Co. v. Pennsylvania Public Utility Comm. 489 Pa. 109, 128, 413 A.2d 1037, 1047 (1980) (quoting *Lumenschein v. Housing Authority*, 379 Pa. 566, 573, 109 A.2d 331, 334-35 (1954)) (emphasis added). This basic jurisprudential tenet was recently and emphatically reaffirmed by this Court in

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Slawek v. Commonwealth, State Bd. of Medical Educ. and Licensure, 526 Pa. 316, 586 A.2d 362 (1991).

It is axiomatic, therefore, that judicial discretion is not to be substituted for administrative discretion. We reaffirm *Norfolk* as the standard for determining whether or not the Insurance Commissioner abused her discretion in formulating the Plan of Rehabilitation. Upon application of the test, should the Commonwealth Court find such an abuse of discretion under the *Norfolk* standard, the Commonwealth Court is limited, by statute, to preventing any further abuse of discretion by either rejecting the plan or modifying the plan and then approving it as modified. 40 P.S. § 221.16(d).

Ordinarily, this Courts review of the Commonwealth Court's actions would be consistent with the traditional appellate review of judicial discretion exercised in a judicial proceeding which is limited to determining questions of law and whether sufficient competent evidence exists to support the exercise of discretion engaged below, as enunciated in *Ben Avon Boro. v. Ohio Valley Water Co.*, 271 Pa. 346 , 114 A. 369 (1921). However, instantly we are reviewing judicial discretion exercised in an area dedicated to the expertise of a given administrative agency, the guidelines for such review of which have been narrowly and specifically stated in *Norfolk, supra.* Therefore, upon review of the Commonwealth Court's discretion, our review must be equally specific and limited in order to remain consistent with the principles of *Norfolk* that restrict judicial discretion to those instances where the agency has abused its discretion.

Accordingly, in order to make a reasonable evaluation of the Commonwealth Court's review of administrative agency activity, in keeping with the principal of *Norfolk,* we adopt the following

three part standard: (1) examination of whether the Commonwealth Court exceeded its statutory authority to approve, disapprove or modify the rehabilitation plan; (2) determine whether the Commonwealth Court substituted any of its own beliefs into the rehabilitation process; and (3) if so, whether the exercise of such discretion was for the prevention of further abuse by the Rehabilitator, and not to change the substance of the plan. Instantly, this limited scope of review is especially appropriate in a highly specialized industry such as insurance, where the skill, judgment and expertise of the Insurance Commissioner are statutorily recognized and deferred to, resulting in a broad scope of discretionary powers.

Numerous other jurisdictions in this country have also held that the decision of a Rehabilitator to rehabilitate the insolvent business of an insurer is within the sound discretion of the rehabilitator and should not be rejected by the reviewing court unless the Rehabilitator has abused that discretion. *Kueckelhan v. Federal Old Line Insurance Co.*, 74 Wash. 2d 304, 444 P. 2d 667 (1968); *Carpenter v. Pacific Mutual Life Insurance Co.*, 10 Cal. 2d 307, 74 P. 2d 761 (1937), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938).

In *Kueckelhan*, the applicable statute involved, Wash. Rev. Code § 48.31.040 (1989), has provisions very similar to the applicable Pennsylvania statutes.[2] There, the Rehabilitator is also directed to take possession of the assets of the insurer and to conduct the business thereof with the goal of removing the causes and conditions which made the rehabilitation necessary. In discussing the role of the courts vis-a-vis the rehabilitative conduct

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2 Due to these similarities between the applicable statute in *Kueckelhan* and the statutes governing insurance rehabilitation in this Commonwealth, we find the rationale of the Washington Supreme Court to be persuasive.

of an Insurance Commissioner, the *Kueckelhan* court stated:

> The courts cannot dictate or outline the general policy or course of conduct of the Insurance Commissioner or his department . . . , because of this outline is dependent on the terms of the applicable statutory provisions and not upon judicial discretion. Our statutory provisions, therefore, properly place the responsibility on both the Insurance Commissioner and the courts, the Commissioner being required to follow the statutory mandates and and to use reasonable discretion in the rehabilitation of a seized company, *with abuses of discretion to be checked by the judiciary.*

Kueckelhan, 74 Wash. 2d at ___, 444 P.2d at 674 (emphasis added) (Citations omitted). The Court in *Kueckelhan* added:

> "Toward this end [the Insurance Commissioner] must be afforded that freedom of action in the over-all management of the company which will permit him to knowledgeably evaluate, plan, devise, and implement a program which in his best judgment and in keeping with his expertise in the field of insurance will accomplish the objective of the proceeding."

Id.

This Court has concluded that this great deference in favor of

the Insurance Commissioner and the resulting narrow scope of review for the courts are in recognition of the expertise of the administrative agency or individual officer assigned the task of regulating a given industry. *See, e.g., Mathies Coal Co. v. Commonwealth, Department of Environmental Resources*, 522 Pa. 7, 559 A.2d 506 (1989); *Brocal Corporation v. Commonwealth, Department of Transportation*, 515 Pa. 224, 528 A.2d 114 (1987); *Pelton v. Commonwealth, Department of Public Welfare*, 514 Pa. 323, 523 A.2d 1104 (1987); *Pennsylvania Bankers Ass'n v. Secretary of Banking*, 481 Pa. 332, 392 A.2d 1319 (1978). Instantly, as the Plan *sub judice*, as modified, was a considered exercise of judgment on behalf of the Insurance Commissioner in her capacity as Rehabilitator and as it was thoroughly supervised and implemented with the capable assistance of the Commonwealth Court, as provided by statute, we cannot interfere with those findings or determinations made below, absent an abuse of discretion. Accordingly, for the reasons that follow, we believe the Plan of Rehabilitation, as modified by the Commonwealth Court, is a legitimate and proper exercise of the Rehabilitator's statutory powers, and properly effectuates the intentions of the rehabilitation statutes. We, therefore, with the exception of an additional modification to Section XVII of the Plan ("Interest"), affirm the Order of the Commonwealth Court.[3]

REHABILITATION v. LIQUIDATION

Appellant Allstate challenges the Plan on the basis that it more properly represents a liquidation plan and as such, it has been improperly implemented under the Rehabilitation portion of the

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3 We restrict our review to only those issues properly raised before, and addressed by, the Commonwealth Court. Those issues now sought to be resolved which were not raised in the Commonwealth Court are deemed to have been waived. *See* Pa. R.A.P. 302(a).

Insurance Act. It is argued that the instant plan does not contemplate a resuscitation of Mutual Fire's operations which is one of the stated purposes of the rehabilitation statute. Further, opponents of the Plan claim it is in violation of *Neblett v. Carpenter,* 305 U.S. 297 (1938), in which the United States Supreme Court held that a rehabilitation plan cannot impose harsher consequences than a liquidation. Under *Neblett,* creditors must fare at least as well under a rehabilitation plan as they would under a liquidation, which Appellants currently argue, would not be the case under this Plan. We disagree and affirm the finding of the Commonwealth Court that this plan properly effectuates the goals of rehabilitation embodies in 40 P.S. § 221.14 *et seq.*

The Commonwealth Court correctly concluded that the ultimate goal of the Plan *is* to have Mutual Fire reemerge as a solvent insurer. The Plan calls for Mutual Fire's possible restructure and orders that it maintain its required capital and surplus minimums required in order to resume operations in the future.

The rehabilitation, in order to be legitimate, does not have to restore the company to its exact original condition. So long as the rehabilitation properly conserves and equitably administers "the assets of the involved corporation in the interest of investors, the public and others, (with) the main purpose being the public good" the plan of rehabilitation is appropriate. 2A *Couch on Insurance* 2d § 22.10. The Plan as it presently appears before this Court does provide the benefits of rehabilitation such as flexibility and the accelerated disposition of claims which the Commonwealth Court properly recognized as preferable to and distinct from, the ordinary procedures of liquidation. The Commonwealth Court after an extensive and thorough analysis concluded that the plan of rehabilitation best effectuates the "legislatively stated purpose (of) 'the protection of the interest of insureds, creditors and the public

generally. . . .' and the 'equitable apportionment of any unavoidable loss' through *inter alia,* 'improved methods of rehabilitating insurers. . . .' Section 501 of the Act, 40 P.S. § 221.1." *Grode v. Mutual Fire, Marine and Inland Insurance Company,* 132 Pa. Commw. Ct. 196, 207, 572 A.2d 798, 803 (1990) (quoting 40 P.S. § 221.1(c)).

Finding no meritorious challenge to the Plan on this issue, and in recognition of the validity of the goals sought and the scheme offered by the rehabilitation, we affirm the Commonwealth Court's holding that this is a legitimate plan of rehabilitation intended for the benefit of the public and not a *de facto* plan of liquidation.

In keeping with our limited and narrow scope of review we will now address *seriatim* the remaining issues raised before and resolved by the Commonwealth Court.

IMPAIRMENT OF CONTRACTUAL RIGHTS

Several objectors to the plan assert that the Plan as proposed impermissibly impairs their various contractual rights. While this may in fact be an accurate assessment of the consequence of the proposed rehabilitation, such impairment is not a *per se* violation of law and we agree with the Commonwealth Court that any actual impairments are insubstantial.

Again, we must look to the broad powers afforded to the Commissioner granted in order to effectuate equitably the intent of the Rehabilitation statutes, i.e., to minimize the harm to *all* affected parties. As such, she has a fiduciary duty to marshall and preserve all assets of the insolvent entity. Furthermore, the exigencies attendant to a major commercial insolvency and the goals of rehabilitation necessitate the reality that "individual interests may need to be compromised in order to avoid greater

harm to a broader spectrum of policyholders and the public." *Vickodil v. Commonwealth, Insurance Department*, 126 Pa. Commw. Ct. 390, 396-97, 559 A.2d 1010, 1013 (1989). *See also Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 103 S. Ct. 697, 74 L. Ed. 2d 569 (1983).[4]

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4 Several Appellants, including the Member Companies of the Republic Group, 24 M.D. App. Dkt. 1990, allege that the setoff provisions impermissibly violate the impairment of contract provisions of both Art. I, § 10 of the United States Constitution and Art. I. § 17 of the Pennsylvania Constitution. In determining when state law may impair a contractual right, the United States Supreme Court in Energy Reserves Group, Inc. v. Kansas Power and Light, 459 U.S. 400 (1983), established a three-part test. The threshold inquiry is to determine whether the state statute in reality has operated to substantially impair a contractual relationship. *Id.* at 411. Should it be determined that a substantial impairment has occurred, the state must set forth a legitimate and significant public purpose. *Id.* at 412-13. Once that purpose is identified, the final inquiry concerns whether the adjustment of contractual rights is reasonable and of a nature appropriate to the public purpose justifying the legislation's adoption; however, if the state is not a contracting party, deference is given to the state's enunciated purpose. *Id.*

We agree with the rehabilitator that the instant Plan satisfies this test. The Commonwealth Court properly upheld this portion of the Plan and concluded that in order to achieve the desired consequence of satisfying all claims in an equitable and orderly manner the resulting alleged contract impairments were insubstantial. Furthermore, the significant interest on behalf of the state to regulate the fiscal affairs of its insurers for the welfare of the public would still render the Plan permissible should impairment be found to exist. It is also worthy to note that the objectors to the Plan are members of a highly regulated industry and as such were well aware of the powers of a Rehabilitator. Accordingly, the Commonwealth Court properly dismissed Appellants' challenge to the setoff provision of the Plan under the federal constitution. As our impairment of contract provision, Art. I, § 17 of the Pennsylvania Constitution, mirrors that the United States Constitution, we are guided by the United States Supreme Courts' analysis in Energy Reserves v. Kansas Power & Light. Therefore, we adopt the same test instantly and likewise dismiss the impairment of contract challenge made under the Pennsylvania Constitution.

Thus, the action of the Rehabilitator fosters the legitimate public purpose of safegarding the public interest from the potentially innumerable consequences of Mutual Fire's insolvency. Accordingly, we find no error or abuse of discretion with this portion of the Plan as it is legitimately designed to ameliorate a financial hazard for the good of all involved. We, therefore, affirm this portion of the Order of the Commonwealth Court.[5]

SETOFF

Next, review of the Plan's setoff provisions requires a three-tiered analysis, as the provisions affect several groups of interested parties differently. Pursuant to the Insurance Act "[M]utual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article shall be set off and the balance only shall be allowed or paid. . . ." 40 P.S. § 221.32(a). This option was immediately challenged as this statutory provision allowing for setoff appears only under the liquidation portion of the Insurance Act, and thus it is argued cannot apply in support of the alleged plan of rehabilitation. As the Commonwealth Court correctly observed, this distinction "evidences an intent that rehabilitation proceedings are distinct from liquidation proceedings." *Grode v. Mutual Fire, Marine & Inland Insurance Co.*, 132 Pa. Commw. Ct. 196, 211, 572 A.2d 798, 805 (1990).

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5 The Commonwealth Court made minor adjustments, extractions and modifications to certain provisions of the Plan, including modifications later in the Plan concerning the allegation of contractual impairment discussed above. We will address these modifications later in the opinion at the appropriate time and place. It is to be noted, however, that most of the modifications to the Plan worked to mitigate certain objections of Appellants and as such they are appropriate.

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However should the plan of rehabilitation as proposed offer significant benefits in serving the public interest, the discretionary action of the Rehabilitator should be approved absent any arbitrary or manifest abuse of discretion. Furthermore, while Pennsylvania common law has long recognized and permitted the concept of setoffs, *Dickerson v. Dickersons Overseas Company,* 369 Pa. 244, 85 A.2d 102 (1952); *In re Kenin's Estate,* 346 Pa. 127, 29 A.2d 495 (1943), their application is not mandatory. Rather, the common law right to setoff, a form of contractual impairment, is an equitable right to be permitted solely within the sound discretion of the court. *In Re Bell,* 147 Pa. Super. 471, 24 A.2d 101 (1942); *Abrahams v. Wilson,* 134 Pa. Super. 297, 3 A.2d 1016 (1939); *Commonwealth ex rel. Sheppard v. Central Penn National Bank,* 31 Pa. Commw. Ct. 190, 375 A.2d 874 (1977).

The second point of contention is raised by Mutual Fire's reinsurers alleging that the Plan improperly includes a provision prohibiting any setoff of *premium obligations due Mutual Fire.* This argument is without merit and was properly rejected by the Commonwealth Court. Existing law, in plain words, expressly forbids a setoff of premium obligations. 40 P.S. § 221.32(b)(4) states in relevant part:

> (b) *No setoff* or counterclaim shall be *allowed* in favor of any person *where:*
>
> > (4) *the obligation of the person is to pay premiums,* whether earned or unearned, to the insurer.

40 P.S. § 221.32(b)(4) (emphasis added). This *express* prohibition, however, appears only in the liquidation portion of the Insurance Act. Appellants argue that since the sole location of the premium

setoff prohibition is in the liquidation section, this precludes its application in a rehabilitation context. However, they fail to recognize the fundamental language of 40 P.S. § 221.32(a). That section begins by stating that the setoff provisions *apply to any action or proceeding "under this article."* 40 P.S. § 221.32(a) (emphasis added). Since the term "this article" refers to Article V of the Act of May 17, 1921, P.L. 789, *as amended,* by the Act of Dec. 14, 1977, P.L. 280, 40 P.S. § 221.1 *et seq.* which encompasses both the sections on liquidation *and* rehabilitation, the relevant provisions regarding setoffs under the liquidation section must also apply to actions proceeding under the statutory rehabilitation provisions. Additionally, the provision of the Plan expressly prohibiting a premium setoff in a *rehabilitation* context, ensures that the creditors herein, at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding as mandated by the holding of *Neblett, supra.*

The goal of rehabilitation is to manage the affairs of an insolvent insurer with the intended result of restoring the entity to sound fiscal status. Instantly, it is essential that all assets flowing into the rehabilitated entity be treated preferentially in order that the insurer have an opportunity to remain afloat and survive. The statute involved implicitly recognizes this necessity to maintain and protect an insurer's principal asset, premiums due, from premature extinguishment. Therefore, the provision of the Plan denying premium setoffs is unquestionably valid and legitimately exercises the Rehabilitator's statutory powers, and thus, will properly remain undisturbed.

Next, various objectors to the Plan challenge the two definitions of setoff offered by the Plan. The first definition, referred to by some Appellants as the "basic setoff definition" or "mandatory setoff definition", provides that: "[s]etoff for purposes

of this Plan shall be calculated as of December 4, 1986.[6] Balances set forth on the books of Mutual Fire shall be conclusive." The only mutual debts and credits that may be setoff against one another are those "Due and Owing[7] on December 31, 1986," *Plan of Rehabilitation* at 14. Objectors complain because this definition limiting setoff to only those debts which are mutual, due and owing, prohibits the application of case reserves and incurred but not reported ("IBNR") claims.

The second definition under the Plan, referred to as the "optional setoff definition", provides:

> E. Election of Optional Setoff Definition
>
> 1. Election. A Reinsurer who is also a Cedent may pay that amount carried on the books of Mutual Fire as currently due and owing within ninety (90) days after the date on which the Court enters an Order approving and confirming the Plan, in which event the Optional Setoff Definition set forth below shall apply to said Reinsurer. Balances set forth on

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6 As originally submitted, this provision of the Plan had provided for a December 31, 1986 calculation date. This date was modified by President Judge Crumlish of the Commonwealth Court as part of his Order, modifying and approving the Plan as modified. This modification was ordered to preserve the fundamental right of the creditors to be treated, at a minimum, as well under the rehabilitation as they would in a liquidation.

7 The term "Due and Owing" is defined in Section I of the Plan as "Reinsurance recoverable on paid losses, paid Loss Adjustment Expenses, Claim Settlements and reimbursement agreements." Plan at 2.

the books of Mutual Fire shall be conclusive for this purpose.

2. *Optional Setoff Definition.* The Optional Setoff Definition shall be as follows:

Any Reinsurer of Mutual Fire who is also a Cedent to Mutual Fire will be permitted to setoff the lesser of Mutual Fire's obligations to the Cedent against the Reinsurer's obligations to Mutual Fire according to Mutual Fire's books pursuant to the following calculation:

Option Setoff Calculation[8] — The lesser of:

a. Mutual Fire's obligation to the Cedent for:

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8 As President Judge Crumlish stated in his opinion concerning his modification of Section III, E.2.a of the Plan, pertaining to reinsurers who are also Cedents:

> ". . . [that Section] shall read so as to compute balance as of December 4, 1986, the date on which the Commissioner filed the petition for rehabilitation. Had the Commissioner petitioned for liquidation rather than rehabilitation on that date, these objector's rights would be fixed as of that filing date. Section 520(d) of the Act, 40 P.S. § 221.20(d). Thus, this Plan modification assures that those objectors receive substantially the same set off rights and treatments they would receive in a liquidation."

Grode v. Mutual Fire, Marine and Inland Insurance Co., 132 Pa. Commw. Ct. 196, 211, 572 A.2d 798, 805 (1990).

balances Due and Owing, plus reported Case Reserves, plus reported IBNR.[9]

All as computed as of December 4, 1986; or

b. The Cedent's obligation to Mutual Fire for:

balances Due and Owing, plus Case Reserves. All as computed as of December 4, 1986.

The reinsurers again object, claiming the optional definition of setoff also fails to allow them to setoff their IBNR obligations to Mutual Fire that had not matured on the date of rehabilitation. Conversely, in support of the Plan's setoff provision and the modification made by the Commonwealth Court concerning the cut off date, the Insurance Commissioner argues: "[I]n so defining setoff, the Plan has given appropriate recognition to the traditional equitable remedy of setoff while limiting it to its appropriate scope by imposing the requirement that only matured, liquidated obligations may be setoff." Brief of Appellee at 57.

While the objections that the Plan effectively denies Appellants their right to setoff obligations to Mutual Fire that had

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9 These terms were defined by Appellee, Insurance Commissioner as follows:

> "Case reserves are estimates of amounts required to cover future payments on account of known claims. IBNR refers to amounts predicted to be paid in the future on account of events that have occured but have not been reported as claims to the insurer.

Appellees Brief at 58 fn. 8.

not matured as of the time it went into rehabilitation is appealing on the surface, it bears repeating that it is a fundamental principle of Pennsylvania law that setoff is an equitable remedy and accordingly, is permissive, not mandatory. *In Re Bell, supra.* Furthermore, no right of setoff can be available against a note or other obligation that does not mature until after a receiver for the insolvent debtor is appointed. *Commonwealth ex rel. Bell v. Trademen's Trust Co.*, 250 Pa. 372, 95 A. 574 (1915). *Accord Appeal of Commonwealth Trust Co. of Pittsburgh*, 324 Pa. 161, 188 A. 200 (1936).

Instantly, we find this analysis especially compelling as case reserves are not present obligations of the reinsurer. Case reserves and IBNR are at most calculations or estimates of future potential liabilities, which often times are contingent upon a later development or growth of the claim or some intervening procedure such as litigation. Their speculative and intangible nature at the time of the petition of rehabilitation does not warrant their being available for setoff against more due and owing or mature obligations.

Assuming *arguendo,* however, that a case was established to support the applicability of case reserves and IBNR to setoff, this does not necessarily automatically create such an entitlement. Once again, it is fundamental that setoff is an equitable remedy within the sound discretion of the Rehabilitator and/or the trial court and absent an abuse of that discretion reviewing courts must refrain from involvement. In keeping with the stated intent of rehabilitation to protect and preserve the estate of the insolvent insurer for the benefit of *all* creditors, we find no error or abuse in denying the reinsurers the windfall which would result from allowing the reinsurer to offset obligations against Mutual Fire that had not matured as of the time the petition for rehabilitation was

filed. The setoff is being permitted, therefore, only to the extent that it encourages and facilitates the ultimate goal of rehabilitation. Accordingly, the setoff provision of the plan and the subsequent modification and approval of that provision by the Commonwealth Court shall also remain undisturbed.[10]

PRIORITY OF DISTRIBUTION[11]

Next, we examine the disposition rendered by the Commonwealth Court regarding the numerous challenges to the Plan's provision establishing the priority of distribution of claims

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10 The Commonwealth Court in modifying, then approving the setoff provision of the Plan also struck down several additional portions of the provision. First, Section III, F., limiting the maximum allowable setoff of $25,000,000 was excised from the Plan as having no explicit or implicit statutory authorization in rehabilitation or liquidation proceedings. Secondly, the Plan's provision in Section III, G., proclaiming Mutual Fire's books and records to be conclusive was also deleted due to the established inaccuracy of those books. We uphold these changes by the Commonwealth Court, pursuant to its statutory power to modify the Plan as caretaker of the Plan, and to correct potentially arbitrary and unjust provisions resulting in a more equitable procedure for all involved.

11 The Plan establishes separate classes of claims for the purpose of the priority of distribution. They are as follows:

> Class 1 — Secured claims; Class 2 — Administrative claims of the Estate and Guarantee Associations; Class 3 — Wage claims; Class 4 — Policyholder claims; Class 5 — Surety Bond Lender claims; Class 6 — General Unsecured claims, including claims of cedents and reinsurers; Class 7 — Government claims; Class 8 — late claims; Class 9 — Holders of Surplus and Contribution Notes; Class 10 — Owners, Officers and Directors.

to Mutual Fire's estate. Preliminarily, we dismiss the first challenge raised to, and addressed by, the Commonwealth Court concerning the Policyholders' objection to the Plan's June 30, 1991, cut-off date for recognition of loss claims. In order to foster the goals of rehabilitation, the Rehabilitator must be given the power to manage and control existing liabilities in order to reorganize and stabilize the financial structure of the insolvent insurer. We approve of the rationale engaged in by the Commonwealth Court when it opined:

> We find, however, no abuse of discretion in fixing this date. Given that Mutual Fire has not written business since mid-1986, a cut-off date set five years out from the cessation of business cannot be considered arbitrary or unreasonable. Moreover, the Rehabilitator has it within her authority to seek modification of that date if she deems it inappropriate. A determination can be better made by examining loss development experience as the 1991 date approaches. Therefore, we approve the June 30, 1991 date for the submission of loss claims as contained in Section II.H and VI.G of the Plan. This Court may, however, in the future direct the Rehabilitator to submit a recommendation as to whether the date should be extended.

Grode v. Mutual Fire, Marine and Inland Insurance Company, 132 Pa. Commw. Ct. 196, 212, 572 A.2d 798, 806 (1990). While the consequence of this date designating a specific date beyond which the filing of loss claims is barred might work some hardships, the procedure is not inflexible and is both reasonable and necessary to

manage effectively the rehabilitation of Mutual Fire for the ultimate benefit of all claimants to the estate.

The next challenge raised before and addressed by the Commonwealth Court concerns the objections of six of the ninety-one banks and financial institutions who, as surety bond lenders, allege they were improperly designated as a separate Class 5 in priority arguing that they were entitled to payment as Class 4 "policyholders." These objectors to the Plan (hereinafter "Lender Group") maintain that surety bonds are insurance policies entitling them to priority treatment under the Plan as Class 4 policyholders. They assert that because the issuance of surety bonds is regulated by the Insurance Department, the participants in Mutual Fire's bond program are entitled to the same priority of distribution under the Plan as Class 4 policyholders.

Initially, the Commonwealth Court recognized that there exist fundamental differences between bilateral contracts of insurance and tripartite surety bond agreements. It concluded that the differences between their respective premium calculations, payments, and terms and conditions of cancellation and renewal, support "the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance." *Id.* at 213, 572 A.2d at 806.

The Commonwealth Court also rejected the previously made assertion that the fact that surety bond issuances are regulated by the Insurance Department is dispositive. Rather, the court adopted the view taken by the United States Supreme Court in *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 140 n. 19 (1962), wherein it stated: "Among the problems which would be raised by a contrary result would be the unsettling of the usual view, grounded in commercial practice, that suretyship is not insurance." *See*

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Cushman, *Surety Bonds on Public and Private Construction Projects*, 46 A.B.A. J. 649, 652-653 (1960). The Commonwealth Court correctly conclude:

> Moreover, accepting for the moment that surety bond coverage might be regarded as insurance because it is regulated by the Commonwealth insurance laws, we find no abuse of discretion in subordinating the claims of the lenders, who have recourse against investors through their own collection efforts, to those policyholders, who will recover only what they can from Mutual Fire's estate and guarantee funds.

Grode, at 214, 572 A.2d at 806. We find no error in the rationale and determinations employed by the Commonwealth Court regarding this issue. Thus, the Comonwealth Court's approval of the Plan's creation of a separate Class 5 subordinating the surety bond lenders claims to those of the Class 4 policyholders was appropriate.

The Plan's established priority of distribution has been further assailed by the Lender Group which objects to the creation of a Class 6 fund. Specifically, Section II, F.6.1 provides the following:

> 1. Creation of Class 6 fund. On or before the Effective date, a segregated Account (the "Class 6 Fund") shall be established by the Rehabilitator. The Class 6 Fund shall be funded by depositing in the Class 6 Fund, from time to time, twenty-five percent (25%) of all reinsurance collected by Mutual Fire, with respect to the assumed reinsurance business of

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> Mutual Fire. All interest earned shall be transferred to the general account of the Rehabilitator and used by the Rehabilitator as a general unliened asset of the estate of Mutual Fire.

Plan at 17.

As the court properly noted in explaining why no abuse of discretion existed on the part of the Rehabilitator in creating separate Classes 5 and 6:

> [T]hese Class 5 lenders, who fall immediately behind the Class 4 policyholder but before Class 6 creditors, stand to benefit by what we perceive is an equitable innovation in the plan. Since under the Act the lenders are entitled to no higher distribution priority than general unsecured creditors, we find that the creation of Class 5 and the creation of a Class 6 segregated account are acts well within the Rehabilitator's discretion which do not violate the dictates of *Neblett*.

Id. at 214, 572 A.2d at 807.

The objectors to this provision maintain that as Class 5 lenders, the creation of the fund inequitably demotes them to a subclass of creditors subordinate to the Class 6 of general unsecured creditors. Because the Insurance Act prohibits the Lenders Group from attaining a higher distribution priority than general unsecured creditors, the Commonwealth Court held that the establishment of a Class 5 and the finding of a separate Class 6 account were

provisions well within the Rehabilitator's broad discretion. Accordingly, the Court stated:

> In sum, we find the creation of both Class 5 and Class 6 to be a proper exercise of the Rehabilitator's discretion. If, after all, insurance is to perform its function of risk assumption and distribution of loss, then those statutes which govern it must first protect the insuring public, particularly in situations where the insurer becomes incapable of covering the risks it contracted to assume. Rehabilitation and liquidation are of vital importance to the consumer, who relies in the first place on the industry itself and then on its regulators for protection. No one can dispute than the consumer is not possessed of equal bargaining power, knowledge, or resources as that of the reinsurance entities and financial institutions which comprise the other major creditor classes in ths proceeding.

Grode at 215, 572 A.2d at 807.

While perfection may be an unattainable characteristic of the Plan, this does not provide us with legitimate grounds for disturbing the more expert approval of provisions which are manifestly reasonable. So long as the provisions of the Plan strike a fair and proper balance between the competing secured and unsecured creditors the Plan must survive the objections raised to it.

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UNITED STATES CLAIMS

The United States government also raises an objection to the Plan, complaining of the Class 7 status to which their claims were assigned. They object, citing 31 U.S.C. § 3713 (1983), known as the Federal Priority Act which in relevant part requires that:

> (a) (1) A claim of the United States *shall be paid first when* —
>
> A) a person indebted to the government *is insolvent. . .*

31 U.S.C. § 3713(a)(1)(A) (emphasis added).

The Rehabilitator responds to this objection by arguing that the McCarran-Ferguson Act prohibits any federal statute from impairing or invalidating any state insurance regulation. 15 U.S.C. § 1012. The Act states in pertinent part: "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance. . . ." 15 U.S.C. § 1012(b). We refrain from deciding the question concerning the applicability of the McCarran-Ferguson Act as did the Commonwealth Court. Suffice it to say, however, that we quote with approval both the factual determination made below and the resulting remedy temporarily ordered by the Comonwealth Court:

> Upon consideration of this objection and the Rehabilitator and other policyholders' responses thereto, we direct the Rehabilitator to set aside an amount which she finds in her discretion to be appropriate to pay United

States Government claims. We further direct her to report to this Court the amount contained in this set-aside fund and will order the Plan to be so modified. We do this with the following considerations in mind.

First, the Rehabilitator avers or contends that the only federal claims Mutual Fire has identified are (1) Federal Savings and Loan Insurance Corporation (FSLIC) receivership claims; (2) Environmental Protection Agency claims, "contingent and undetermined" according to the proofs of claims filed, against *insureds* of Mutual Fire; and (3) claims made by Westinghouse Electric Corporation against whom the United States may have claims. The United States does not dispute this averment that only these subrogated and third-party claims have arisen so far. We do not agree that the existence of these claims renders Mutual Fire a "person indebted to the Government," within the meaning of the Federal Priority Act. That is not to say, however, a debt due the United States could not arise, or that no federal claim *will* be filed.

Grode, at 216, 572 A.2d 798. 808 (emphasis in original).[12]

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12 We are aware of decisions from other jurisdictions which do not recognize the McCarran-Ferguson Act as barring the federal government from obtaining first priority status in insolvency proceedings. Matter of Union Indemnity Ins. Co. of New York, 551 N.Y.S.2d 446, 146 Misc. 2d 558 (1990) (IRS unaffected by McCarran-Ferguson Acts regulation or insurance business). Instantly, the primary federal presence regarding claims against Mutual Fire concerns claims made by the Federal Deposit Insurance Corporation ("FDIC") and the Federal Savings and Loan

(Cont'd)

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JUDGMENT CREDITORS

Pepsi-Cola Bottling Company of Charlotte, North Carolina, Inc. (hereinafter "Pepsi"), appeals from the Commonwealth Court's approval of the plan, alleging that as a federal court judgment holder against Mutual Fire, the principle of the Full Faith and Credit Clause of the United States Constitution mandates that it be given full payment, including interest, due to an alleged superiority of its claim, irrespective of the insurance rehabilitation proceedings.

Initially, the contention by Pepsi that it is entitled to an elevated priority by virtue of its status as a federal court judgment holder is both unsubstantiated and without merit. This theory is unsupported by existing case law and neither the provisions of 40 P.S. § 221.14 *et seq.* providing for rehabilitation, nor 40 P.S. § 221.19 *et seq.* providing for liquidation, contemplate a specific elevated priority for judgment creditors. As the Commonwealth

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(Cont'd)

Insurance Corporation ("FSLIC"). However, as the FDIC has been held not to be an integral part of the government scheme, FDIC claims have not been held to be a "claim of the United States Government," 31 U.S.C. § 3713, which would therefore be entitled to priority. Lapadula v. Villani, Inc. v. United States, 563 F. Supp. 782 (S.D.N.Y. 1983). The FSLIC, has been held, in terms of its function, as identical to FDIC. *See* In Re Federal Savings and Loan Insurance Corporation, 837 F.2d 432, 434 (11th Cir. 1988); Federal Savings and Loan Insurance Corporation v. Quinn, 419 F.2d 1014, 1017 (7th Cir. 1969); Federal Savings and Loan Insurance Corporation v. Williams, 599 F. Supp. 1184 1204 (D. Md. 1984). As the regulation of insurance companies both solvent and insolvent has been conceded to the states and since the goal of 15 U.S.C. § 1012 was to exempt insurance activities from federal antitrust laws to preserve the state regulation of insurance companies, it would appear that the McCarran-Ferguson Act operates to preclude the applicability of the Federal Priority Act.

Court stated in refuting this contention: "On the contrary, the serving of a judgment does not elevate the status of such claims." *Grode* at 217, 572 A.2d 798, 808 (*citing Davis v. Commonwealth Trust Co.*, 335 Pa. 387, 7 A.2d 3 (1939)).

While Pepsi may not be expressly entitled to an elevated priority for purposes of Class 4 distribuion, another facet of the Plan's treatment of Pepsi warrants our discussion. Pepsi alleges that its judgment, including interest, against Mutual Fire was filed on September 4, 1986, one week before the Insurance Commissioner suspended the business of Mutual Fire and three months before the Commissioner filed the Petition for Rehabilitation. In approving the Plan, however, the Commonwealth Court recognized that the judgment in favor of Pepsi against Mutual Fire "is binding on and cannot be altered by the Rehabilitator." *Grode* at 217, 572 A.2d 798, 808. The problem concerns Section XVII of the Plan which expressly prohibits the payment of interest to creditors unless provided for in the Plan. Thus, an apparent inconsistency exists which resulted in Pepsi filing a Motion For Clarification of the Commonwealth Court's Order approving the Plan, a motion which appears to remain without a ruling.

The case relied upon by both parties, *Davis v. Commonwealth Trust Co.*, 335 Pa. 387, 7 A.2d 3 (1939), while proper authority to deny Pepsi's earlier claim of elevated priority, is not analogous for purposes of the instant dilemma concerning the viability of interest awarded. In *Davis*, the issue concerned the claim of a creditor which had been awarded a judgment against the liquidating trustee by a court *years after the liquidation started.* Pepsi's judgment entered September 4, 1986 provides:

NOW, THEREFORE, IT IS ORDERED,

> ADJUDGED AND DECREED that on its first claim for relief, denominated First Count in the complaint, plaintiff Pepsi-Cola Bottling company of Charlotte, Inc. have and recover of an from defendant The Mutual Fire, Marine and Inland Insurance Company the principal sum of One Million Two Hundred Thousand Dollars ($1,200,000.00), plus interest thereon at the legal rate, eight percent (8%) per annum, from and after the date of the breach, May 21, 1986, plus costs.

The Court noted that this judgment is binding, inviolate and not subject to any alteration by the Rehabilitator. We view that statement as an implied modification of the Plan's interest prohibition contained in Section XVII as respects Pepsi-Cola Company of Charlotte, Inc. While the Rehabilitator's equitable powers do afford her the authority to limit or deny interest which accrues *after a petition for rehabilitation or liquidation has* been filed, the federal judgment held by Pepsi including the amounts for interest expressly provided for from May 21, 1986 must be accepted and given dignity up until December 4, 1986, the date the Insurance Commissioner sought to invoke her equitable powers

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13 This result, we believe, properly satisifes the results of applicable case law. Under the Full Faith and Credit Clause, Article Four, Section One of the United States Constitution, and an implementing statute, 28 U.S.C. Section 1738, Pepsi's federal court judgment is to be accepted by the states as conclusive proof of the rights adjudicated. *See* Stroll v. Gottlieb, 305 U.S. 165, *reh'g denied*, 305 U.S. 675 (1938). The result of disallowing the payment of interest on Pepsi's judgment for any period beyond the date the Petition of Rehabilitation was filed, is also consistent with those decisions wherein courts have held that interest accruing on claims after insolvency proceedings have begun is payable only after the principal on all claims have been paid in full. American Iron and Steel Manufacturing Co. v. Seaboard Airline Railway, 233 U.S. 261, 266 (1914); Commw. ex rel. Woodside v. Seaboard Mutual Casualty Co., 420 Pa. 237, 215 A.2d 673 (1966).

pursuant to her Petition for Rehabilitation.[13]

Accordingly, we remand this issue to the Commonwealth Court for the purpose of modifying its January 23, 1990 Order, in favor of maintaining Pepsi-Cola Bottling Company of Charlotte, Inc. as a Class 4 policyholder creditor, for the full amount of the federal judgment entered on September 4, 1986, including all interest provided for between May 21, 1986 and December 4, 1986.

LOSS ADJUSTMENT EXPENSES

Numerous claimants have objected to the Plan complaining about the provision contained therein which provides for equal sharing of loss adjustment expenses by Mutual Fire and its policyholders as of April 1, 1989. These expenses are extensive, resulting from the necessity to retain a competent staff to manage and oversee the rehabilitation, a staff of claim adjusters, claim investigators and legal counsel. While many retainer arrangements were well intended, they were entered into prior to the insolvency. Now, presented with a dire need to economize in order to survive, the Rehabilitator must lead the process, free to eliminate or reduce many of the self-serving interests involved. While the effect of the Plan may cause economic suffering to some private contracting parties, we remain mindful that when an insurance company becomes insolvent, individual interests might have to be sacrificed or compromised in order to preserve the ultimate goal of this process, the overall good of the general public and the insurer's policyholders. *Vickodil v. Commonwealth Insurance Department*, 126 Pa. Commw. Ct. 390, 396-97, 559 A.2d 1010, 1013 (1989).

Accordingly, we find no error on behalf of the Commonwealth Court's modifying and approving the following portions of the loss

adjustment expenses provision of the Plan. First, it is unquestionably reasonable to make modifications to the Plan which instill in it greater flexibility, mitigate some of the harsher consequences and emphasize a process of scrutiny which will guarantee a regular review of costs and expenses and a general system of accountability to the Court. We, therefore, adopt with approval the following language employment by the Commonwealth Court:

> Notwithstanding these changed conditions, in order to minimize the possibility of prejudice to the policyholders whose claims Mutual Fire is obligated to defend, we will modify Section IX of the Plan and direct that loss adjustment expenses be shared equally as provided in the Plan, but not until ninety days from the date of the Order entered today. We extend the date for the reduction of full payment of loss adjustment expenses in order to minimize any adverse consequences on the defense of claims.
>
> At the same time, we will further Order the Rehabilitator to review *all* employment and retainer agreements, including those of outside counsel and consultants employed with the Court's approval, with the aim toward renegotiation, where appropriate, and reduction of fees and expenses. It is obvious, though worth repeating, that each dollar expanded in administrative and unreinsured loss adjustment costs and fees is a dollar taken away from the payment of claims. We therefore view this as a task of vital importance to the insureds and claimants and require that it be

undertaken forthwith.

Grode at 218-19, 572 A.2d 798, 809 (emphasis in original).

PROPORTIONAL PAYMENTS METHOD

Section VI of the Plan allows for interim partial payments made periodically on Class 4 Adjusted Claims (Policyholder Loss Claims and Guaranty Association Loss Claims) of $5,000.00 or less per Adjusted Claim as cash is available. After a thorough review of this provision, the Commonwealth Court approved the Plan with the following modifications: first, payments were required to be made pursuant to this provision by June 1, 1990 according to a payment schedule and schedule of distribution dates submitted for the Court's approval; second, the Court modified the Plan "so that payments of these small claims to single persons or entities with more than one claim shall be taken into account in the proportional payment program." *Grode* at 219, 572 A.2d at 809. The Commonwealth Court agreed with the Policyholders Committee that "this latter modification will minimize the preference otherwise given to policyholders with multiple claims." *Id.*

The small payment provision will accelerate the disposition of numerous claims which would otherwise develop into greater expense to the estate. The payment of small claims whether adjusted or not by the date of the order approving the plan is likewise, legitimate and reasonable. As the Commonwealth Court properly reasoned, a distinction between adjusted claims or unadjusted claims which limited payment under this provision solely to unadjusted claims, "would punish these claimants who

have thus far cooperated with the estate by resolving disputes and settling claims during the pendency of these proceedings." *Id.*

MISCELLANEOUS PROVISIONS

With regard to the Commonwealth Court's disposition of the jurisdictional issue, 40 P.S. § 221.4, we are in complete agreement. Article V of the Insurance Act simply and plainly recognizes the Commonwealth Court's exclusive jurisdiction over delinquency proceedings. 40 P.S. § 221.4(d) ("All actions . . . shall be brought in the Commonwealth Court in the Commonwealth of Pennsylvania"). Accordingly, it was appropriate for the Court to strike Sections VIII (c) and (e) as being inconsistent with the provisions of that Article. Conversely, it was also proper for the Court to approve Sections (a), (b), (d), (f) and (g) as they were viewed to correctly invoke the exclusive jurisdiction of the Commonwealth Court over matters concerning the interpretation of the Plan and the rehabilitation itself pursuant to 40 P.S. § 221.4. Additionally, Section X.A, concerning dispute resolution of claims other than those subject to arbitration, was likewise approved below. The court's interpretation that the provision permits parties to a dispute to *request* the commonwealth Court's intervention and resolution in lieu of arbitration is correct. We find no grounds for our intervention here.

DISSOLUTION OF THE POLICYHOLDERS COMMITTEE

Next, a large controversy surrounds the Plan's proposal to dissolve the Policyholders Commitee appointed January 28, 1987 by the Court. The Commonwealth Court dissolved the Committee by Order of November 22, 1989.

The Policyholder Committee complains that not only is the

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Policyholder Class entitled to continued representation but that continued separate representtion of the Class is necessary for adequate representation of the interests of Mutual fire policyholders. Thus, they allege tht the Commonwealth Court erred in dissolving the Committee. The Rehabilitator responds claiming that the real issue is not whether the Commonwealth Court acted improperly but whether she abused her discretion by determining that the Committee's fees and expenses should no longer be paid out of the estate of Mutual Fire after November 22, 1989. The Commonwealth Court, after thorough review of the competing positions, rejected the objections to the dissolution and concluded that those considerations of fairness which compelled the creation of the Policyholder Committee no longer existed in view of the outrageous cost its continued presence would have on Mutual Fire's diminished estate. We agree.

The Commonwealth Court concluded, that by virtue of the instant plan and expecially due to the "hardship" and "proportional payment" provisions contained therein, those parties in particular need of protection, i.e., the small policyholders, now have their interests represented and protected. *Grode,* 132 Pa. Commw. at 222, 572 A.2d at 811. This unquestionably satisfies the statutorily charged duty of the Rehabilitator to protect the interests of Mutual Fire insureds. Likewise, we adopt the rationale of the Commonwealth Court in approving its rejection of the Committee's claim that dissolution leaves the policyholders unrepresented. As President Judge Crumlish reasoned:

> As we have stated, the rehabilitator is statutorily charged with that duty. Moreover, dissolution of the Policyholders Committee means only that this Court will not authorize payments of its costs and fees from Mutual

> Fire's estate. The Policyholders Committee may, as it sees fit, continue its activities outside the Court's groups known as the "lender group" and "cedents' group." Of course, individual policyholders also continue to have an opportunity to be heard.

Id.[14]

We next consider the Commonwealth court's elimination of Section XIII B, the immunity provision contained in the Plan, on the basis that it was unjustified and superorogatory since no such provision in the Plan "may confer upon the Rehabilitator, her deputies or agents immunity greater than that given by Pennsylvania law as codified in Sections 8501-8528 and 8541-8564 of the Judicial code, 42 Pa. C.S. §§ 8501-8528, 8541-8564." *Grode* at 222-23, 572 A.2d at 811. Sections 8521 *et seq.* of the Judicial Code, 42 Pa. C.S. § 8501-8528 dealing with Sovereign Immunity, expressly enumerate the limited exceptions to the general prohibition against holding a Commonwealth Agency and any of its employees liable with respect to acts within the scope of their office or agency. The Rehabilitator and her deputies as agents of the Commonwealth are controlled by these provisions and its limitations. Accordingly, the Commonwealth Court reasonably eliminated the immunity provision as unnecessary and inconsistent with the controlling, applicable statutes regarding Soverign Immunity.

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14 The Plan, once approved should be structured to equitably address all eventualities, conflicts and concerns. As we view the Plan to most efficiently and equitably do so, the role of the Policyholder Committee as representative of policy holder interests is no longer necessary. Indeed, in view of the testimony offered regarding the Committee's numerous attempts to interfere with the Plan, ignore Orders of the Court and bill the estate of Mutual Fire millions of dollars in expense and fees, its continued presence may be an unacceptable financial detriment.

Finally, we address the Plan's indemnification agreement and the Commonwealth Court's approval of this provision. First, the Policyholders Committee argues that certain employment agreements entered into by the Rehabilitator ought to be disapproved. Specifically, they seek to eliminate the employment of more than one deputy and strike those portions of the agreements with the appointed deputies and other employees which contain indemnification agreements. We agree with the Commonwealth Court, who in rejecting this contention stated that pursuant to 40 P.S. § 221.16(a) and (b) the Rehabilitator is given

> express power to "appoint a special deputy who shall have all the powers of the Rehabilitator" and who shall "serve at the pleasure of the Commissioner." In addition, the Rehabilitator "shall have full power to direct and manage, to hire and discharge employes . . . ." We do not find it unreasonable or arbitrary that the Rehabilitator has chosen to appoint a deputy and an "assistant special deputy" to implement a rehabilitation and to manage an estate of this magnitude.

Grode at 223, 572 A.2d at 811. We find no fault with this rationale or conclusion.

The Policyholders Committee also argues that indemnification agreements between the Rehabilitator and her deputies are necessarily void as against public policy, relying upon *Dilks v. Flohr Chevrolet, Inc.*, 411 Pa. 425, 192 A.2d 682 (1963), and *In re Hodgson's Estate*, 342 Pa. 250, 20 A.2d 294 (1941). First, despite these objections, the Commonwealth Court upheld the indemnity provisions and their legitimacy, distinguishing the

present matter from *Hodgson's Estate, supra,* in which the rule applied in the context of testamentary trust litigation. The court held that the rehabilitation deputies do not act in the same fashion as executors or administrators in a probate context. The court then rejected the Policyholders Committees' reliance upon *Dilks, supra,* which it held did not "stand for the proposition that exculpatory clauses, which may be voided as against policy, *Boyd v. Smith,* 372 Pa. 306, 94 A.2d 44 (1953), and *indemnity* provisions receive the same treatment under Pennsylvania law." *Grode* at 224, 572 A.2d at 812 (emphasis in original). Rather, the Commonwealth Court found persuasive and relied upon the reasoning of the United States Court of Appeals for the Third Circuit in *Jamison v. Ellwood Consolidated Water Co.,* 420 F.2d 787, 789 (3d Cir. 1970), to reach its conclusion that the public policy concerns regarding exculpatory clauses were not determinative of the legality of indemnity agreements. Furthermore, the court identified some valid policy concerns in support of its rejection of the Policyholders Committees' arguments and in upholding the appropriateness of the idemnity agreement, stating:

> In order to attract persons of proven ability, that necessity dictates that those persons be somehow insulated from the fears and costs of possible litigation by naturally disgruntled claimants and other creditors who will inevitably suffer some loss. To this end, the Rehabilitator has adopted a reasonable policy of indemnifying her deputies for all actions within the scope of their appointed duties.

Grode, at 225, 572 A.2d at 812.

Appendix A

While the Plan as modified and approved by the Commonwealth Court and as modified by this Opinion may adversely affect some individual interests, we believe that it legitimately seeks to equitably apportion unavoidable losses and is free from arbitrary or capricious provisions which would render the Plan unacceptable as an abuse of the Rehabilitator's discretion.

Accordingly, after a thorough review of the objections presented and the various components of the Plan, we remand Section XVII of the Plan to the Commonwealth Court to modify that provision consistent with this Opinion. We approve the remaining provisions of the Plan as modified by the Commonwealth Court. Affirmed in part, remanded in part.

Mr. Justice Larsen and Mr. Justice McDermott did not participate in the consideration or decision of this case.

DATED: August 21, 1992
JUDGMENT ENTERED:

s/ Mildred E. Williamson
DEPUTY PROTHONOTARY

APPENDIX B — OPINION AND ORDERS OF THE COMMONWEALTH COURT OF PENNSYLVANIA

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

NO. 3483 C.D. 1986

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,

Plaintiff

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,

Defendant.

BEFORE: HONORABLE JAMES CRUMLISH, JR., President Judge

HEARD: July 25, 26, 28, and August 1, 1989

OPINION

OPINION BY
PRESIDENT JUDGE CRUMLISH, JR.

FILED: January 23, 1990

Constance Foster, Commonwealth Insurance Commissioner, as statutory Rehabilitator (Rehabilitator), has petitioned this Court for approval of her modified Plan of Rehabilitation (Plan) for The Mutual Fire, Marine and Inland Insurance Company (Mutual

Fire), a mutual casualty insurance company created and chartered under the laws of Pennsylvania. Commissioner Foster seeks this Court's approval pursuant to Section 516(d) of Article V of the Act of May 17, 1921, P.L. 789, *as amended*, added by the Act of December 14, 1977, P.L. 280, 40 P.S. § 221.16(d) (known as The Insurance Company Law of 1921 (Act)). We modify the Plan in part and hereby approve it.

Before proceeding with disposition of the Plan and the various objections thereto, we briefly summarize the events leading to this decision.

Mutual Fire, founded in 1902, was primarily a property and casualty insurance carrier for most of its history. In the late 1970's, Mutual Fire, along with others in the industry, became more heavily entrenched in reinsurance arrangements with other carriers. Generally speaking, under these arrangements, Mutual Fire ceded a portion of its business to other insurers who agreed to protect Mutual Fire from the risks it undertook. Conversely, Mutual Fire assumed business from other insurers under the same or similar agreements. By the mid-1980's, between 60% and 70% of Mutual Fire's business entailed reinsurance, involving over 8,000 agreements or "treaties" worldwide. At approximately that time, Mutual Fire also wrote a large number of surety bonds as part of financing packages for oil, gas and real estate limited partnerships. In addition, Mutual Fire's "direct book" liability coverage began to show diminishing profitability.

We need not dwell too long, however, on the causes of Mutual Fire's financial straits for purposes of this determination. Suffice it to say that at year-end 1988, immediately before the present Plan was proposed, Mutual Fire's deficit was over $400 million,

constituting the country's fourth largest insurer insolvency.[1]

THE 1987 PLAN OF REHABILITATION

In December 1986, George F. Grode, then Commonwealth Insurance Commissioner, sought, with the consent of Mutual Fire's officers and directors, appointment as Rehabilitator of Mutual Fire, Section 515(a) of the Act, 40 P.S. § 221.15(a), and submitted a rehabilitation plan. Prior to his petition, Commissioner Grode had placed Mutual Fire under his supervision. Section 510(d) of the Act, 40 P.S. § 221.10(d).[2] At the time the petition was filed, Mutual Fire reported assets of $99.4 million and total liabilities of $260.1 million, with a negative policyholders surplus of nearly $161 million.[3]

When it became apparent to this Court that adequate notice had not been given to policyholders and other creditors on whom the original plan would have a direct and substantial impact, hearing on its approval was continued generally. At the same time, we directed the Insurance Department to prepare a notice of hearing to be sent to all known policyholders and creditors indicating the procedure for obtaining the plan and raising objections prior to a Court hearing on its approval. Thereafter,

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1. McLeod, "New Mutual Fire Rehabilitation Plan Proposed." *Business Insurance*, March 6, 1989, at 3.

2. The supervision order was entered September 13, 1986. Such orders enjoin the insurer from disposing, conveying or encumbering assets; withdrawing bank accounts; lending or investing funds; transferring properties; incurring debts or other obligations or entering any new reinsurance contracts without prior approval. 40 P.S. § 221.10(d).

3. Annual Statement 1986, Exhibit No. 7, 7/26/89.

many objections were made. These objections were drawn from individual policyholders, claimants against policyholders, reinsurers doing business with Mutual Fire, creditors and agents of Mutual Fire.

In early 1987, upon application of several policyholders, also objectors to the plan, this Court formed a Committee of Policyholders (Policyholders Committee), whose purpose was to "consult with the statutory rehabilitator on the administration of this matter and advise those represented as to the proposed plan."[4] This Court formed the Policyholders Committee with the express intent of assuring that policyholders *first and foremost* suffered the least amount of harm resulting from the unfortunate series of events culminating in this insurance company's reorganization effort.[5]

The Rehabilitator, now Commissioner Foster, thereafter filed her responses to the objections to the proposed rehabilitation plan. The Policyholders Committee and numerous other parties strenuously objected to this proposed plan on the grounds, *inter alia*, that the Rehabilitator had released no financial information or

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4. Order of January 28, 1987.

5. The liquidation provisions of Article V elevate the "claims under policies for losses wherever incurred, including third party claims, against the insurer for liability for bodily injury or for injury to or destruction of tangible property which are not under policies . . .," Section 544(c) of the Act, 40 P.S. § 221.44(c), to the highest priority of distribution after wage claims, 40 P.S. § 221.44(a), and administrative expenses, 40 P.S. § 221.44(b). Although there is no Pennsylvania authority directly on point, we agree with decisions in other jurisdictions construing similar insurance insolvency statutes that the equitable purpose of rehabilitation and liquidation is to protect *first of all* consumers of insurance. *See, e.g., State ex rel. Long v. Beacon Insurance Co.*, 87 N.C. App. 72, 359 S.E.2d 508 (1987).

documentation to substantiate the projections of 100% payment to policyholders contained therein. Hence, this Court ordered the Rehabilitator to allow the Policyholders Committee and all interested persons access to Mutual Fire's books and records. A hearing date was then set for June 3, 1987.

At that hearing, various stipulations by and among the objecting parties (including the Policyholders Committee) were entered. The proposed plan was approved, subject to those stipulations, which altered it materially but in a manner not pertinent to this discussion.

Several months later, the Rehabilitator, pursuant to this Court's Order approving the proposed plan, filed a report on the progress of the rehabilitation for the period December 8, 1986 (the date on which the statutory Rehabilitator was appointed) to October 26, 1987. At the same time, the Rehabilitator sought additional time to evaluate the feasibility of its implementation. We granted the Rehabilitator's request for additional time and directed her to submit to the Court a schedule of tasks to be performed in order to complete the evaluation.[6] Among these tasks were the engagement of litigation counsel to investigate possible causes of action by the Rehabilitator on behalf of Mutual Fire, Section 516(c) of the Act, 40 P.S. § 221.16(c); the appointment of a professional firm to perform actuarial analyses of Mutual Fire's loss reserves; and the engagement of auditing and claims settlement services, Section 516(b) of the Act, 40 P.S. § 221.16(b). At that time, the Rehabilitator opposed the Policyholders Committee's motion to appoint an independent manager to oversee the rehabilitation on site.

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6. Order of October 27, 1987.

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On May 2, 1988, the Rehabilitator filed her report on the feasibility of implementing the amended plan approved June 26, 1987. After close consultation, pursuant to Section 515(c) of the Act, 40 P.S. § 221.15(c), this Court and Commissioner Foster determined that any viable rehabilitation of this magnitude would necessarily demand sufficient legal, managerial, financial and technical resources. It was therefore decided that initially a deputy rehabilitator would be appointed, Section 516(a) of the Act, 40 P.S. § 221.16(a), and legal counsel would be retained to investigate possible sources of recovery through litigation where litigation was deemed fruitful to collect the recoverables comprising a significant portion of this estate's assets.[7]

On June 1, 1988, having reviewed the Rehabilitator's report on plan implementation, which indicated the 1987 plan was not feasible for several reasons, we directed the Rehabilitator to submit a modified plan.[8] The plan was to include a provision to trigger applicable state insurance guarantee funds (both in Pennsylvania and other states) and a provision for proportionate

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7. Since that time, the Rehabilitator has by writ of summons or complaint instituted legal action against, *inter alia*, Peat, Marwick, Main & Co., seeking damages of in excess of $350 million; GET Reinsurance Limited, seeking damages in excess of $13 million; the Berwind Corporation for 18 U.S.C. § 1962 ("RICO") violations, fraud and other causes of action. The Rehabilitator has also brought suit against Chesapeake Insurance Company, Ltd.; and Keswick & Curran, Incorporated. Additional litigation will be commenced when it is determined to be in the best interest of the estate.

8. Order of June 1, 1988. In her feasibility report, the Commissioner indicated, *inter alia*, that reserves on a portion of Mutual Fire's direct book were substantially in excess of estimates assumed in the 1987 plan; that collection of reinsurarce recoverables would require resort to protracted litigation; and that an assumed favorable resolution of Mutual Fire - "Resolute Re" arbitration had not at that time occurred.

periodic payments of policyholder claims. Additional counsel was hired to assist the Rehabilitator in formulating a modified plan.

Thereafter, the Rehabilitator applied to this Court for approval to suspend payment of certain loss adjustment expenses incurred under Mutual Fire's obligations to defend its insureds. The Rehabilitator also asked this Court for a determination that Mutual Fire was insolvent.[9]

The Rehabilitator submitted a new Plan of Rehabilitation January 31, 1989. After notice was issued to policyholders and all known creditors and was published in periodicals of general and industry circulation, numerous objections were filed. This Court, over the course of four days, heard testimony and argument in support of and against certain provisions of the Plan. It is this Plan and the objections filed thereto which we now address.

REHABILITATION v. LIQUIDATION

Objections to the Plan were raised on the grounds that it is, in name only, a rehabilitation and is in effect a liquidation. The objectors argue, therefore, that the Rehabilitator should be ordered to liquidate Mutual Fire. Several objectors maintain that it is anomalous to rehabilitate an insurance company that has been determined insolvent. We are not persuaded by their arguments, however.

Initially, we recognize that insolvency is one of several

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9. On February 3, 1989, this Court, after examining Mutual Fire's records, determined it to be insolvent as that term is defined in Section 503 of the Act, 40 P.S. § 221.3. We expressly declined to make a finding as to when Mutual Fire became insolvent. This determination of insolvency triggered guaranty fund association coverage.

expressly enumerated grounds on which an order of rehabilitation may be based. Section 514(1) of the Act, 40 P.S. § 221.14(1). Thus, the statute admits of circumstances in which insolvent insurers are to be rehabilitated. *See, e.g., Insurance Department v. Safeguard Mutual Insurance Co.*, 18 Pa. Commonwealth Ct. 195, 336 A.2d 675 (1975), *aff'd as modified*, 478 Pa. 592, 387 A.2d 64? (1978).

The statute authorizes the *Commissioner to petition the Commonwealth Court* for liquidation, Section 517 of the Act, 40 P.S. § 221.17, and an order to liquidate requires notice and hearing. Section 520 of the Act, 40 P.S. § 221.20. The Rehabilitator has not put forth such a petition.

Moreover, we agree with the Rehabilitator and, at least one objector to the Plan, that the benefits of rehabilitation — its flexibility and avoidance of inherent delays — are preferable to the static and cumbersome procedures of statutory liquidation. The statute's purpose is, in the end, that to which we must give effect. That legislatively stated purpose is "the protection of the interests of insureds, creditors, and the public generally. . . ." and the "equitable apportionment of any unavoidable loss" through, *inter alia*, "improved methods for rehabilitating insurers. . . ." Section 501 of the Act, 40 P.S. § 221.1. No interest is served by adding to the delay which has already occurred in this case. On the contrary, the goals of Article V of the Act are better served by a rehabilitation which effectively ensures more distribution in a shorter period of time than would occur in liquidation. *See Neblett v. Carpenter*, 305 U.S. 297 (1938).[10]

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10. Objectors rely in *Neblett* for the proposition that the Rehabilitator cannot fashion a Plan which does not give a party in rehabilitation the same or greater *rights* than he would have in liquidation. The effect of this principle on the Rehabilitator's proposed Plan will be discussed later in this opinion.

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Notwithstanding those objectors' protestations that this is a *de facto* liquidation, we find nothing in the statute precluding the Rehabilitator from pursuing this rehabilitation as an improved method for rehabilitating insurers, particularly where the record indicates that affected persons, including the objecting creditors, would, *at least in terms of amounts* recovered, fare better under this rehabilitation than in statutory liquidation. Rehabilitator's Exhibits Nos. 5 and 6, 7/25/89.

The Plan itself calls for Mutual Fire's possible corporate restructure, and Mutual Fire will maintain its required capital and surplus minimums. The record also indicates that rehabilitation will preserve the value of Mutual Fire's insurance charters and perhaps the even greater value of operating losses. Notes of Testimony (N.T.), 7/25/89, pp. 88-90. This Court is aware of at least two instances where potential buyers have approached the Rehabilitator's deputy. N.T., 7/25/89, pp. 151-152. Of course, no one disputes that the rehabilitation as proposed contemplates the windup of Mutual Fire's current business, but it is not altogether accurate to say that the Rehabilitator intends no rehabilitative purpose. It must be remembered that Mutual Fire's assets, liabilities and operations were of a far smaller order of magnitude prior to the expansion of the reinsurance and surety bond business in the late 1970's and early 1980's.

This Court has held that the Act itself evidences the General Assembly's intent to treat rehabilitations and liquidations as separate, distinct proccedings. *Muir v. Transportation Mutual Insurance Co.*, 105 Pa. Commonwealth Ct. 156, 523 A.2d 1190 (1987). The differences between the rehabilitation and liquidation provisions are readily apparent. The liquidation provision fixes the rights and liabilities of the insurer and its creditors as of a date certain, Section 521 of the Act, 40 P.S. § 221.21; the rehabilitation statute is silent on this matter. The liquidation provision

establishes an order of distribution, Section 544 of the Act, 40 P.S. § 221.44; the Act's rehabilitation section does not. Significantly, the liquidation provision expressly allows for setoffs, Section 532 of the Act, 40 P.S. § 221.32; no such mention is made in that part of the statute governing rehabilitations.

The lack of express direction governing rehabilitations where it is otherwise given in liquidation proceedings compels the conclusion that the Insurance Commissioner, as Rehabilitator, is given broader discretion to structure a rehabilitation plan than is given to her as statutory liquidator. *Id.* In limiting this discretion, the General Assembly has given this Court, by virtue of the Judicial Code, 42 Pa. C.S. § 761(a)(3), and Section 504(a) of the Act, 40 P.S. § 221.4(a), the jurisdiction and authority to oversee rehabilitation proceedings in this Commonwealth. The Court may "approve . . . disapprove . . . or modify" a plan proposed to it. 40 P.S. § 221.16(a). We are aware, however, of the well-settled principle that judicial discretion may not be substituted for administrative discretion. *Blumenschein v. Housing Authority of Pittsburgh*, 379 Pa. 566, 109 A.2d 331, *appeal dismissed*, 350 U.S. 806 (1954).

Thus, we perceive that the Rehabilitator's broad powers in these proceedings are circumscribed by this Court's mandate to act as a check on potential discretionary abuse and to insure equitable apportionment of loss. Of course, the Rehabilitator is constrained by constitutional mandate.

As has been noted, many objectors rely on *Neblett* to urge that the Rehabilitator has abused her discretion in fashioning a plan which affords to interested persons less rights than those they would enjoy in liquidation. Without conceding that the proposed Plan has this effect, the Rehabilitator agrees that *Neblett* requires

claimants be treated the same or better than liquidation. We shall not belabor this point except to agree the parties that the Plan must also be viewed in the light of this principle.

IMPAIRMENT OF CONTRACTUAL RIGHTS

Several objectors contend that the Plan unlawfully impairs their various contractual rights. This Court finds that these alleged impairments are, for the most part, insubstantial and do not warrant modification of the Plan except as hereinafter provided.

The Act and caselaw implicitly recognize that contractual terms are not sacrosanct when an insurance company is insolvent. *See Vickodil v. Insurance Department*, ___ Pa. Commonwealth Ct. ___, 559 A.2d 1010 (1989). As in public utilities, the insurance industry is subject to particularly strict regulation by state government because the impact of an insolvent insurer's contracts is not limited to the named parties. *See Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400 (1983). This is particularly applicable to the contracts for reinsurance without which Mutual Fire would have been unable to expand its business. Rather, those contracts entered into by Mutual Fire have affected thousands of members of the public of course, individual parties to those contracts cannot be expected to protect this public interest. Thus, the General Assembly, pursuant to its inherent police power to safeguard the public interest, has authorized the Commissioner to represent these interests in order to minimize the harm to all affected parties — insureds, creditors and the public generally — from the potentially devastating consequences of insurance insolvency. 40 P.S. § 221.1. If the Commissioner determines that rehabilitation, as opposed to liquidation, is the most efficient means of representing these interests, and this Court finds no abuse of her discretion, then contractual impairments that are insubstantial and reasonably necessary to implement a

rehabilitation plan cannot be deemed unlawful. *Energy Reserves Group*. "[A]n impairment may be constitutional if it is reasonable and necessary to serve an important public purpose." *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 25 (1977). We are convinced that Mutual Fire's rehabilitation serves an important public purpose. Hence, we examine the "extent of impairment[s]" to determine their reasonableness. *Id.* at 27.

Except for the Plan modifications outlined in this opinion, the Court finds that the alleged contractual impairments are insubstantial and reasonably designed to enable the Commissioner to satisfy *all* claims in an equitable and orderly manner.

SET OFF

The Plan as now proposed contains, in effect, three definitions of offset. The first provides that mutual debt and credits are only those Due and Owing[11] on December 31, 1986. The optional definition, which may be elected by reinsurers who are also cedents by paying the amount due and owing Mutual Fire within ninety days of plan approval, is the lesser of Mutual Fire's obligation to a cedent for Due and Owing, plus reported case reserves, plus Incurred But Not Reported ("IBNR") losses as of March 31, 1986, *or* the cedent's obligation to Mutual Fire for balances due and owing, plus case reserves as of December 31, 1986. Lastly, insurers paying Due and Owing within ninety days of Plan approval will receive a 10% discount if they waive any and all rights to setoff.

We will examine the optional setoff definition contained in

11. The term "Due and Owing" is in turn defined as reinsurance recoverable on *paid* losses, *paid* loss adjustment expenses, claim settlement and reimbursement agreements. Section I.II of the Plan (emphasis added).

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Section III.E.2 , the definition most generous to Mutual Fire's creditors according to the record, Rehabilitator's Exhibit No. 4, 7/25/89, on the assumption that those creditors using the more restrictive definition have consented to do so.

We first note that Article V's rehabilitation section contains no definition of setoff while the liquidation provision does. We have already stated that this evidences an intent that rehabilitation proceedings are distinct from liquidation proceedings. *Muir*. If the Rehabilitator's formulation of a plan is not arbitrary or unreasonable, then that plan should be approved if it does not diminish the rights a creditor would have in liquidation.

The Plan's treatment of rights of setoff, found not only in specific contracts but also in common law, must be modified as follows.

Section III.E.2.a, pertaining to setoff by reinsurers who are also cedents, shall read so as to compute balances as of December 4, 1986, the date on which the Commissioner filed the petition for rehabilitation. Had the Commissioner petitioned for liquidation rather than rehabilitation on that date, these objectors' rights would be fixed as of that filing date. Section 520(d) of the Act, 40 P.S. § 221.20(d). Thus, this Plan modification assures that those objectors receive substantially the same setoff rights and treatments they would receive in a liquidation.

Section III.F., placing a $25,000,000 cap on total allowable setoff is stricken. There is no provision for a maximum setoff allowance in liquidation proceedings and no legal justification for this restriction.

Further, the Plan's provisions, proclaiming Mutual Fire's books and records to be conclusive, are stricken. Due to the

established inaccuracy of Mutual Fire's records, this condition substantially impairs the objectors' right to an accurate accounting. Therefore, the Plan is modified to provide that the figures in Mutual Fire's books may be contested through the Plan's claims and disputes resolution procedures.

PRIORITY OF DISTRIBUTION

A. Cut-Off Date for Submission of Class 4 Loss Claims

The Policyholders Committee and (not surprisingly) individual policyholders whose businesses expose them to a "long tail" of liability, object to June 30, 1991, as the cut-off date for recognition of loss claims. The Plan as proposed provides that all such claims reported thereafter will be included in Class 8 ("late claims") priority.

We find, however, no abuse of discretion in fixing this date. Given that Mutual Fire has not written business since mid-1986, a cut-off date set five years out from the cessation of business cannot be considered arbitrary or unreasonable. Moreover, the Rehabilitator has it within her authority to seek modification of that date if she deems it inappropriate. A determination can be better made by examining loss development experience as the 1991 date approaches. Therefore, we approve the June 30, 1991 date for the submission of loss claims as contained in Section II.H and VI.G of the Plan. This Court may, however, in the future direct the Rehabilitator to submit a recommendation as to whether the date should be extended.

B. Lenders as Policyholders

Six of the ninety-one banks and financial institutions which

participated in the Mutual Fire surety bond program have jointly objected to their placement in Class 5 of the Plan's distribution schedule. Known informally as "the Lender Group," these lenders have put forth their view that the surety bonds are insurance policies, entitling them to treatment under the Plan as Class 4 policyholder recipients.

This theory has engendered much controversy in these proceedings, and its proponents as well as opponents have referred us to a wealth of authority for their respective positions. Despite this, our research has revealed no Commonwealth precedent which holds squarely that a surety bond is (or is not) an insurance policy. Thus, we view this as an issue of first impression. For the reasons which follow, we conclude that participants in Mutual Fire's surety bond program are not entitled to the same treatment as Class 4 claimants.

First, we acknowledge the fundamental differences pointed out to this Court between bilateral contracts of insurance and tripartite surety bond agreements. Unlike insurance policies, surety bond premiums are not determined by the insurer on the basis of loss but rather on the *lender's* evaluation of risk. Premiums are paid *not by the lenders* but by the investors; they are paid "up-front" and are not subject to adjustment. The instruments have no fixed terms and no right of cancellation or renewal. These factors support the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance.

Second, we do not find it dispositive that the issuance of these bonds is regulated by the Insurance Department. *Group Life & Health Insurance Co. v. Royal Drug Co.*, 440 U.S. 205 (1979); *see also* Backman, *Surety Rate-Making* (1948). If, as the lenders argue,

the best evidence of the lenders' policyholder status is provided by the bond instrument itself, then there is ample argument in the instrument's title, "Financial Surety Bond for Limited Partnerships," to counter the notion that the use of the term "policy" in the documents render them insurance contracts. Regardless, we must look beyond these contradictory references and any other nomenclature contained therein to examine the essence of these transactions. We adopt, as has the United States Supreme Court, "the usual view, grounded in commercial practice, that suretyship is not insurance." *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 140 n. 19 (1962); *see also American Insurance Association v. Clarke*, 656 F. Supp. 404 (D.C. 1987) (municipal bond "insurance" is a bank credit transaction functionally equivalent to a standby letter of credit).

Moreover, accepting for the moment that surety bond coverage might be regarded as insurance because it is regulated by the Commonwealth insurance laws, we find no abuse of discretion in subordinating the claims of the lenders, who have recourse against investors through their own collection efforts, to those of policyholders, who will recover only what they can from Mutual Fire's estate and guarantee funds.

We find that, even if these bonds were contracts of insurance, the legislature has excluded them from coverage under The Pennsylvania Insurance Guaranty Association Act, Act of November 25, 1970, P.L. 232, *as amended*, 40 P.S. § 1701.101—1701.605. This exclusion evidences an intent not to afford surety holders the protections given by this Act to consumers of insurance whose carrier becomes insolvent.

For these reasons, we conclude that participants in the surety bond lender program would not fall within the same claimant class as "direct book" policyholders were Mutual Fire in liquidation.

Thus, their rights are not diminished by placement in Class 5 of the Plan's distribution schedule. Accordingly, we approve Section II.E of the Plan.

C. Creation of Class 6 and Class 6 Fund

The Lender Group has objected to the creation of a segregated Class 6 fund to be funded by the deposit of 25% of all reinsurance Mutual Fire collects. No portion of this fund shall be paid unless and until this Court enters an Order authorizing initial distribution, and until Class 4 loss claims are paid in full.

The Lender Group, who stands to receive distributions in Class 5 before general creditors in Class 6, argues that this set-aside is inequitable and renders them a sub-class of creditors junior to general unsecured creditors (i.e., principally cedents) in violation of the Act's liquidation provisions.

However, these Class 5 lenders, who fall immediately behind the Class 4 policyholders but before Class 6 creditors, stand to benefit by what we perceive is an equitable innovation in the Plan. Since under the Act the lenders are entitled to no higher distribution priority than general unsecured creditors, we find that the creation of Class 5 and the creation of a Class segregated account are acts well within the Rehabilitator's discretion which do not violate the dictates of *Neblett.*

In sum, we find the creation of both Class 5 and Class 6 to be a proper exercise of the Rehabilitator's discretion. If, after all, insurance is to perform its function of risk assumption and distribution of loss, then those statutes which govern it must first protect the insuring public, particularly in situations where the insurer becomes incapable of covering the risks it contracted to

assume. Rehabilitation and liquidation are of vital importance to the consumer, who relies in the first place on the industry itself and then on its regulators for protection. No one can dispute that that consumer is not possessed of equal bargaining power, knowledge, or resources as that of the reinsurance entities and financial institutions which comprise the other major creditor classes in this proceeding.

D. United States Claims

United States claims are treated under the Plan as Class 7 claims. The United States government objects to the Plan because it does not accord first priority of payment of debts due the United States. It is asserted that this treatment violates 31 U.S.C. § 3713 (1983), known as the Federal Priority Act, which requires that a United States government claim "shall be paid first when . . . a person indebted to the Government is insolvent. . . ."

The Rehabilitator counters that the Federal Priority Act is inapplicable to these proceedings because the McCarran-Ferguson Insurance Regulation Act, 15 U.S. C. § 1012 (1976),[12] precludes the impairment or invalidation of state insurance law by any federal statute.

Upon consideration of this objection and the Rehabilitator and other policyholders' responses thereto, we direct the Rehabilitator to set aside an amount which she finds in her discretion to be appropriate to pay United States government claims. We further direct her to report to this Court the amount contained in this set-

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12. 15 U.S.C. § 1012(b) provides, in pertinent part: "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance. . . ."

aside fund and will order the Plan to be so modified. We do this with the following considerations in mind.

First, the Rehabilitator avers or contends that the only federal claims Mutual Fire has identified are (1) Federal Savings and Loan Insurance Corporation (FSLIC) receivership claims; (2) Environmental Protection Agency claims, "contingent and undetermined" according to the proofs of claims filed, against *insureds* of Mutual Fire; and (3) claims made by Westinghouse Electric Corporation against whom the United States may have claims. The United States does not dispute this averment that only these subrogated and third-party claims have arisen so far. We do not agree that the existence of these claims renders Mutual Fire a "person indebted to the Government," within the meaning of the Federal Priority Act. That is not to say, however, a debt due the United States could not arise, or that no federal claim *will* be filed.

Second, although we need not decide today whether the McCarran-Ferguson Act applies to preclude the application of the Federal Priority Act, we have already recognized that the Commonwealth's Insurance Company Law governing rehabilitations is, as was said in *SEC v. National Securities., Inc.*, 393 U.S. 453 (1969), "aimed at protecting or regulating this relationship [between insurer and insureds] directly or indirectly." *Id.* at 460. Thus, Article V would be deemed a law regulating the "business of insurance." *Id.*[13]. If, after all, liquidation of insolvent insurance companies were *not* the business of insurance relegated

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13. Notwithstanding the Ninth and Fourth Federal Circuit decisions to the contrary, we note the Third Circuit has stated that state-regulated insurance insolvencies are the business of insurance authorized by McCarran-Ferguson. *Lac D'Amiante Du Quebec, Ltee v. American Home Assurance Co.*, 864 F.2d 1033 (3d Cir. 1988), citing *United States Service Auto Association v. Muir*, 792 F.2d 356 (3d Cir. 1986), *cert. denied*, 479 U.S. 1031 (1987).

to the states' governance by McCarran-Ferguson, the federal Bankruptcy Code would obviate the need for this statute and similar acts in other states. Hence, McCarran-Ferguson would appear to preclude the application of the Federal Priority Act.

E. Judgment Creditors

Pepsi-Cola Bottling Company of Charlotte, Incorporated, (Pepsi-Cola), has objected to the Plan on the ground that as a federal court judgment holder against Mutual Fire, it is entitled to elevated priority when distributions are made to Class 4 policyholders. Although we agree that this judgment is binding on and cannot be altered by the Rehabilitator, Pepsi-Cola points to no authority — and we have found none — for the position that it is entitled to payment before other policyholders.

Neither the rehabilitation nor liquidation provisions of Article V sets forth any priority for judgment creditors. On the contrary, the serving of a judgment does not elevate the status of such claims. *Davis v. Commonwealth Trust Co.*, 335 Pa. 387, 7 A.2d 3 (1939).

Accordingly, we approve Section II of the Plan as modified, consistent with our determination that a set-aside be provided for United States government claims.

LOSS ADJUSTMENT EXPENSES

No less than fifteen claimants have objected to the Plan's provision for the equal sharing of loss adjustment expenses by Mutual Fire and its policyholders as of April 1, 1989.

We are painfully aware of the magnitude of this — the largest current expense of the estate — and of the drain it causes, on

Mutual Fire's resources. Most, if not all, of the retainers and employment agreements were negotiated by Mutual Fire or its authorized agents prior to its suspension and rehabilitation. It stands to reason that those persons did not have the same incentive to economize which representatives of an insolvent estate necessarily possess. Everyone now, though, must recognize the changed circumstances which have led to this rehabilitation proceeding.

Notwithstanding these changed conditions, in order to minimize the possibility of prejudice to the policyholders whose claims Mutual Fire is obligated to defend, we will modify Section IX of the Plan and direct that loss adjustment expenses be shared equally as provided in the Plan, but not until ninety days from the date of the Order entered today. We extend the date for the reduction of full payment of loss adjustment expenses in order to minimize any adverse consequences on the defense of claims.

At the same time, we will further Order the Rehabilitator to review *all* employment and retainer agreements, including those of outside counsel and consultants employed with the Court's approval, with the aim toward renegotiation, where appropriate, and reduction of fees and expenses. It is obvious, though worth repeating, that each dollar expended in administrative unreinsured loss adjustment costs and fees is a dollar taken away from the payment of claims. We therefore view this as a task of vital importance to the insureds and claimants and require that it be undertaken forthwith.

PROPORTIONAL PAYMENTS METHOD

The Rehabilitator proposes,[14] as part of the Plan's

14. This proposal was also embodied in the Rehabilitator's motion for authority to pay small claims filed August 11, 1989.

proportional payment methodology, to make the first distribution to pay "small claims" — those of $5,000 and under — "as soon as practicable following the effective date of this Plan." We view this innovation an effective and expeditious means of carrying out the Rehabilitator's statutory mandate and find it to be an "equitable apportionment of unavoidable loss." Consequently, we approve it but with the following modifications.

We will require the Rehabilitator to make payments under this distribution no later than June 1, 1990. We will also require the Rehabilitator to submit a schedule of payments made under this provision of the Plan and direct her to establish a schedule of distribution dates which she deems appropriate. Additionally, we will modify the Plan so that payment of these small claims to single persons or entities with more than one claim shall be taken into account in the proportional payment program. We agree with the Policyholders Committee that this latter modification will minimize the preference otherwise given to policyholders with multiple small claims.

The Policyholders Committee also urged us to allow small claims payment only to those claims *not adjusted* as of the Plan approval date. Underlying this argument is the rationale that immediate adjustment and payment of small claims will save the estate costs concomitant with the continuing management of the outstanding, unadjusted claims. While this rationale applies in part to the Rehabilitators proposed methodology, we believe such a distinction is inequitable and punishes those claimants who have thus far cooperated with the estate by resolving disputes and settling claims during the pendency of these proceedings. We will, therefore, approve the payment of small claims whether adjusted or unadjusted as of this date.

Appendix B

MISCELLANEOUS PROVISIONS

A. Jurisdictional Statement

Article V defines the Commonwealth Court's jurisdiction. "No court of this Commonwealth shall have jurisdiction to entertain, hear or determine any delinquency proceeding other than as provided in this article." Section 504 of the Act, 40 P.S. § 21.4.

The statute contemplates that the Commissioner shall petition this Court for rehabilitation and thereafter be appointed statutory rehabilitator. 40 P.S. § 221.15. The Commissioner, as Rehabilitator under the Court's supervisory aegis, is empowered to "pursue all appropriate legal remedies on behalf of the insurer." 40 P.S. § 221.16(c).

In any court in this state before which any action is pending when a rehabilitation order is entered, the Rehabilitator may request a stay. 40 P.S. § 221.17(a). This Court then shall order the Rehabilitator to take such action in that "pending litigation as the court deems necessary . . . ." In addition, the Rehabilitator is directed "to consider all litigation pending outside this Commonwealth and shall petition the courts having jurisdiction over that litigation for stays whenever necessary . . . ." *Id.*

Thus, the plain language of the statute provides for the Commonwealth Court's exclusive jurisdiction over delinquency proceedings themselves, while recognizing that other courts have jurisdiction over pending proceedings by or against an estate in rehabilitation. Although the Rehabilitator refers us to decisions in other jurisdictions which found an *implied* grant of exclusive

jurisdiction to the receivership court,[15] we are not permitted to ignore the statute's plain language in a search for legislative intent.

We disagree with the Rehabilitator that the jurisdictional provision contained in the present Plan is nearly identical to that the Court approved on May 18, 1987. Sections VIII (c) and (e) differ in material respects and we will strike them in whole or in part. Sections (a), (b), (d), (f) and (g) comport with Article V's grant of exclusive jurisdiction in *delinquency* proceedings because they invoke our exclusive jurisdiction in this Commonwealth over matters connected to interpretation of the Plan — and implementation of the rehabilitation itself — including its provisions for asset collection and claims disputes. We therefore approve them.

Likewise, we approve Section X.A, governing disputes other than claims subject to arbitration. We construe this section as permitting parties to a dispute to *request* Commonwealth Court resolution in lieu of arbitration.

B. Committee Dissolution

The Rehabilitator has in the Plan proposed that the Policyholders Committee appointed January 28, 1987, by the Court be dissolved.[16] This Court, by Order of November 22, 1989, so dissolved the Committee.

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15. *In the Matter of Allcity Insurance Co.*, 413 N.Y.S. 2d 929, 66 A.D.2d 531 (1979), and *United States v. Bank of New York & Trust Co.*, 296 U.S. 463 (1936) (adopting New York Court's construction of state law in *People by Beha v. Russian Reinsurance Co.*, 255 N.Y. 415, 175 N.E. 114 (1931)).

16. The Rehabilitator by motion of April 6, 1989, had previously asked this Court to suspend payment of the Policyholders Committee's counsel fees and costs. Because of our determination of this Plan provision, we will now dismiss this motion as supererogatory.

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Notwithstanding the Committee's argument that policyholders as a class would thereby be without representation, we took this action for the following reasons.

Primarily, the rehabilitation statute conveys to the Rehabilitator the authority and the *duty* to protect the interests of Mutual Fire's insureds. 40 P.S. § 221.1(c). The Rehabilitator has taken possession of Mutual Fire's assets and, by her deputies, continues to administer its business and property, "under the orders of the Court." 40 P.S. § 221.15(c). In instances where she deemed it necessary she has pursued (and will pursue) litigation on behalf of Mutual Fire. She has now proposed a Plan which upon examination and as modified, we find gives due consideration to Mutual Fire's policyholders and other creditors as well.

In addition, the Rehabilitator has petitioned for the establishment of a program to pay outstanding claims under $5,000; a provision for "hardship" claims; and a proportional payment methodology. These procedures, as now modified in the Plan, will protect those policyholders (and claimants) with little or no recourse except to Mutual Fire insurance. Thus, the most damaging exposure to small, "mom and pop" policyholders has been minimized. As the Policyholders Committee has repeatedly stated in its numerous motions and briefs, the rationale underlying its existence and functions is to protect the policyholder class.

Thus, we conclude that the need this Court perceived when equitable considerations dictated the Policyholders Committee's formation no longer exists. Consequently, we find that this cost to Mutual Fire's diminished estate can no longer be justified.

Moreover, dissolution of the Committee does not leave policyholders unrepresented. As we have stated, the Rehabilitator is statutorily charged with that duty. Moreover, dissolution of the

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Policyholders Committee means only that this Court will not authorize payments of its costs and fees from Mutual Fire's estate. The Policyholders Committee may, as it sees fit, continue its activities outside the Court's aegis, as have the other creditors' groups known as the "lender group" and "cedents' group." Of course, individual policyholders also continue to have an opportunity to be heard.

Accordingly, we approve Section XVI.I of the Plan.

C. Immunity Provision

Because no provision for immunity contained in the Plan can *in any case* confer upon the Rehabilitator, her deputies or agents immunity greater than that given by Pennsylvania law as codified in Sections 8501—8528 and 8541—8564 of the Judicial Code, 42 Pa. C.S. §§ 8501—8528; 8541—8564, we will strike this section of the Plan as supererogatory. We emphasize that we do not by this action decide the question of the Rehabilitator's immunity.

D. Indemnification Agreement

The Policyholders Committee has also, by separate motion,[17] sought disapproval of certain employment agreements which the Rehabilitator has entered into in connection with her powers under 40 P.S. § 221.16(a) and (b). The Policyholders Committee would have us disapprove the employment of more than one deputy and strike those parts of any agreements containing indemnification provisions for appointed deputies and other employees.

However, the above-mentioned section of Article V gives the Rehabilitator express power to "appoint a special deputy who shall

17. Policyholders Committee Objection, March 9, 1989.

have all the powers of the rehabilitator" and who shall "serve at the pleasure of the commissioner." In addition, the Rehabilitator "shall have full power to direct and manage, to hire and discharge employes. . . ." We do not find it unreasonable or arbitrary that the Rehabilitator has chosen to appoint a deputy and an "assistant special deputy" to implement a rehabilitation and to manage an estate of this magnitude.

Next, the Policyholders Committee refers to authority which it argues would require us to find indemnification agreements between the Rehabilitator and her deputies void as against public policy. Relying on *Hodgson's Estate*, 342 Pa. 250, 20 A.2d 294 (1941), and *Dilks v. Flohr Chevrolet*, 411 Pa. 425, 192 A. 2d 682 (1963), the Policyholders Committee maintains that the indemnity contract to which it objected cannot be entered into because its terms exempt one charged with public service from liability. We find the Committee's arguments unpersuasive in this rehabilitation context, however.

First, *Hodgson's Estate* decided issues raised in testamentary trust litigation. While there is some analogy between an executor or administrator and the Rehabilitator's deputies in this rehabilitation, it has been noted that a receiver's possession of assets is not precisely that of a trustee, but is merely a figurative way of stating that the receiver must hold the property for the benefit of others, albeit in a fiduciary capacity.[18]

We also note that *Miller v. Jacobs*, 361 Pa. 492, 65 A.2d 362 (1949), another testamentary estate decision on which the Policyholders Committee relies, stated the general rule that estate administrators are liable individually but "[w]hether the executor

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18. Couch on Insurance 2d (Rev. ed. 1984) § 22:45.

or administrator may have *indemnity* out of the estate is of no concern to third persons." *Id.* at 495 n. 1, 65 A.2d 364 n. 1 (emphasis added).

Nor does *Dilks* stand for the proposition that *exculpatory* clauses, which may be voided as against policy, *Boyd v. Smith*, 372 Pa. 306, 94 A.2d 44 (1953), and *indemnity* provisions receive the same treatment under Pennsylvania law. Rather, we find persuasive the Third Circuit's reasoning in *Jamison v. Ellwood Consolidated Water Co.*, 420 F.2d 787, 789 (3d Cir. 1970):

> The difference between ... [exculpatory clauses and indemnity agreements] is manifest and significant. A valid exculpatory clause precludes recovery by the victim of the negligence. In contrast, a valid indemnity provision in no way affects the victim's right of recovery.... The Dilks opinion shows an awareness that indemnity and exculpatory clauses are sufficiently similar that the same rules of construction may often be used. However, Dilks clearly did not go so far as to say that the public policy considerations determinative of the legality of exculpatory clauses are necessarily determinative of the legality of indemnity clauses.

On the contrary, the Rehabilitator's action in agreeing to indemnity is reasonably related to public policy considerations governing insurance company rehabilitation.

The necessity of finding experienced and competent deputies is recognized by the statute. "The commissioner shall make such

arrangements for compensation as are necessary to obtain a special deputy of proven ability." 40 P.S. § 221.16(a).

In order to attract persons of proven ability, that necessity dictates that those persons be somehow insulated from the fears and costs of possible litigation by naturally disgruntled claimants and other creditors who will inevitably suffer some loss. To this end, the Rehabilitator has adopted a reasonable policy of indemnifying her deputies for all actions within the scope of their appointed duties. We therefore by Order of March 17, 1989, approved the Rehabilitator's request for this employment agreement.

CONCLUSION

Having considered all objections and found that the proposed Plan, with modifications, constitutes an equitable apportionment of unavoidable loss, is in the best interests of insureds and other creditors, and does not constitute an abuse of the Rehabilitator's discretion, we modify the Plan consistent with this opinion and approve it in all other respects.

Date: January 23, 1990

s/ James Crumlish, Jr.
James Crumlish, Jr.
President Judge

Appendix B

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

NO. 3483 C.D. 1986

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,

Plaintiff

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,

Defendant

ORDER

The Rehabilitator's January 31, 1989 Plan of Rehabilitation in the above-captioned matter is modified as follows:

1. The Rehabilitator shall set aside funds which she deems adequate to satisfy any and all possible debts due to the United States Government from The Mutual Fire, Marine and Inland Insurance Company's (Mutual Fire) estate. The Rehabilitator shall advise the Court when this amount is determined and describe the nature of the potential claims for which funds have been set aside. The Rehabilitator shall also notify the United States Government of its determination.

2. Section II.J. is amended to read:

J. Class 10: Owners, Officers and Directors

To the extent of cash available after full

payment of all Class 9 claims, payments shall be made to Policyholders as of December 4, 1986, other than in their capacity as Class 4 claimants, in proportion to the annual premiums for the policies then in force.

3. Section III.D., first paragraph, is amended to read:

Setoff for purposes of this Plan shall be calculated as of December 4, 1986. No setoff shall be allowed or paid in those situations described in 40 P.S. § 221.32(b)(1) through (4). Within ninety (90) days of final approval of the Plan, the Department shall notify each creditor of the amount of setoff as calculated by the Rehabilitator. This notice shall contain a statement advising each creditor that it shall have thirty (30) days from receipt of said notice to object to the Rehabilitator's calculation, or that calculation shall be deemed final. In the event of an objection, the dispute shall be resolved pursuant to the Claim Resolution Procedures set forth in Section VII of this Plan.

4. Section III.E.2. is amended to read:

a. Mutual Fire's obligation to the Cedent for: balances Due and Owing, plus reported Case Reserves, plus reported IBNR.

All as computed as of December 4, 1986; or

b. The Cedent's obligation to Mutual Fire

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for: balances Due and Owing, plus Case Reserves.

All as computed as of December 4, 1986.

Mutual Fire's IBNR is specifically excluded from section (b.) of this calculation.

To the extent that Case Reserves are set off and the claims relating to those case reserves ultimately are settled at a value less than the reserved amount, Reinsurer who is also a Cedent shall remit, in cash, the balance to Mutual Fire.

5. Section III.F. of the Plan is stricken in its entirety.

6. Section VI.A. is amended to read:

Interim Partial Payments

Interim Partial Payments shall be made periodically on Class 4 adjusted claims (Policyholder Loss Claims and Guaranty Association Loss Claims) as each is available, in the manner set forth below.

1. The first distribution to Class 4 shall be made as soon as practicable following the effective date of this Plan, but no later than December 1, 1990. The Rehabilitator shall pay after the effective date Class 4 claims of $5,000.00 or less per adjusted claim as and

when adjusted out with the first payment not later than June 1, 1990.

2. Unless otherwise Ordered by the Court, distributions shall thereafter be made to Class 4 adjusted claims at least annually.

3. Payments of Class 4 claims to Class 4 claimants with more than one claim under $5,000.00 shall be treated as advances against distributions under the Proportional Payments Method described herein. No Class 4 claimants who receive payment for multiple small claims shall receive distribution under the Proportional Payment Method until all the Class 4 claimants first receive an equal percentage distribution on their adjusted claims.

7. Section VI.C.1.b. is amended to read:

b. The first distribution respecting claims adjusted between Record Dates ("laterAdjusted Claims") shall cause each such Claim to receive an amount equal to the cumulative percentage paid on earlier Adjusted Claims so that all Adjusted Claims as of a given Record Date shall receive, on a cumulative basis, proportionally equal distributions as of each Distribution Date.

8. Section VI.C.4. is amended to read:

Upon notice as the Court shall require, all

assets held and segregated pursuant to this Section VI by the Rehabilitator, after Class 4 Claims are paid in full or reserved for payment in full, shall be released for payment to Classes 5 through 10.

9. Section VII, second paragraph, is amended to read:

Whenever objections are filed and served, the Rehabilitator shall seek a hearing and give notice of the hearing by first class mail to the Claimant or its attorney not less than thirty (30) days before the date of the hearing. The matter may be heard by the Court or by a court-appointed referee or master who shall submit findings of fact along with his recommendation. Claimants shall cooperate with the Rehabilitator in an effort to settle and adjust Claims.

10. Section VIII.(c) is modified to read:

(c) to hear, determine and where appropriate refer to arbitration, all disputes concerning Claims and the collection of assets of Mutual Fire, including reinsurance and retrocessions;

11. Section VIII(e) is stricken.

12. Section XIII.B. is amended to read:

No action at law or equity shall be brought against Mutual Fire or the Rehabilitator or any

employee, agent or representative of the Rehabilitator, whether in the Commonwealth of Pennsylvania or elsewhere, nor shall any such existing actions be maintained or further prosecuted, nor shall any counterclaim or staff be asserted in any action brought by or on behalf of the Rehabilitator, whether in Pennsylvania or elsewhere, except as permitted under the terms of this Plan or by the Courts.

The last sentence of Section XIII.B. is stricken.

13. Section XVI.B. is amended to read:

B. Financial Reports

The Rehabilitator shall submit to the Court an annual budget for each year. The Rehabilitator shall also file quarterly financial reports with the Court showing Mutual Fire's current financial condition, a balance sheet, an income statement, a cash flow statement, a statement of operating and administrative expenses. The Rehabilitator shall also file status reports on reinsurance and asset collections, claims reported and adjusted, and such supporting schedules as are necessary to present Mutual Fire's financial condition fairly.

14. The Plan, including each provision except where amended by this Order, is approved in all other respects.

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Date: January 23, 1990

s/James Crumlish, Jr.
James Crumlish, Jr.
President Judge

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IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

NO. 3483 C.D. 1986

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,

Plaintiff

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,

Defendant

ORDER

NOW this 26th day of February, 1990, this Court's Order of January 23, 1990, is hereby amended as follows:

Paragraph No. 6 of said Order is amended to read:

> Interim Partial Payments shall be made periodically on Class 4 adjusted claims (Policyholder Loss Claims and Guaranty Association Loss Claims) as cash is available, in the manner set forth below.

Paragraph No. 12 of said Order is amended to read:

> No action at law or equity shall be brought

against Mutual Fire or the Rehabilitator or any employee, agent or representative of the Rehabilitator, whether in the Commonwealth of Pennsylvania or elsewhere, nor shall any such existing actions be maintained or further prosecuted, nor shall any counterclaim or setoff be asserted in any action brought by or on behalf of the Rehabilitator, whether in Pennsylvania or elsewhere, except as permitted under the terms of this Plan or by the Courts.

Paragraph No. 11(A) is hereby added to said Order.

11(A). The second paragraph of Section IX Loss Adjustment Expenses is amended to read:

Loss Adjustment Expenses related to the employment of all investigators, adjustors and counsel who are retained by the Rehabilitator or Mutual Fire or either of their authorized agents to investigate, adjust and defend Claims asserted against Mutual Fire's Policyholders ("Professionals") shall be shared equally by Mutual Fire and its Policyholders effective April 23, 1990. The Rehabilitator reserves the right to further reduce or terminate payment of Loss Adjustment Expenses in the event that cash flow is inadequate. Loss Adjustment Expenses will be paid as aforesaid by Mutual Fire only if Policyholders pay their share of Loss Adjustment Expenses and retain the services of Professionals previously approved or hereafter approved by the Rehabilitator.

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s/ James Crumlish, Jr.
James Crumlish, Jr.
President Judge

Appendix B

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

NO. 3483 C.D. 1986

GEORGE F. GRODE, INSURANCE COMMISSION OF THE COMMONWEALTH OF PENNSYLVANIA,

Plaintiff

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,

Defendant

ORDER

Upon consideration of the applications of the Rehabilitator and various other parties for clarification of this Court's January 23, 1990 Order, said Order is amended to conform with this Court's direction that all provisions on the conclusiveness of Mutual Fire's books and records contained in the Rehabilitator's Modified Plan of Rehabilitation be stricken.

The sentence, "Balance set forth on the books of Mutual Fire shall be conclusive for this purpose." is hereby stricken from Section III, E.1 and III, G. of the Rehabilitator's Modified Plan of Rehabilitation.

Dated: April 18, 1990

s/ James Crumlish, Jr.
James Crumlish, Jr.
President Judge